

An Analysis of Cost Contribution Arrangements as a Legitimate Transfer Pricing Instrument and a Tax Avoidance Tool



Dennis Nijssen



An Analysis of Cost Contribution Arrangements as a Legitimate Transfer Pricing Instrument and a Tax Avoidance Tool

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Table of Contents

List of Abbreviations	13
Preface	15
Acknowledgements	17
 Part 1: Introduction	 19
 1. Justification	 21
1.1. Introduction	21
1.2. Definition of a CCA	22
1.3. Example	23
1.4. Relevance of Research	25
1.4.1. Cost deductibility and Effective Ownership of Intangible Assets	25
1.4.2. Base Erosion and Profit Shifting	27
1.5. Purpose of Research	29
1.5.1. Research Objectives	29
1.5.2. Limitations of Scope	30
1.6. Methods and Materials	32
1.6.1. Methodology	32
1.6.2. Sources of information	33
1.7. Contents	35
 2. Concept and Use	 39
2.1. Introduction	39
2.2. The CCA Concept	40
2.2.1. Uncontrolled Joint Development Arrangements	40
2.2.2. Controlled Joint Development Agreements	43
2.2.3. Legal Status	52
2.3. Application in Fiscal Practice	54
2.3.1. Legitimate Use	54
2.3.2. Tax Avoidance	56
2.3.3. Demarcation Lines	68
2.4. Conclusions	75

Part 2: Transfer Pricing Aspects	79
3. General Transfer Pricing Considerations	81
3.1. Introduction	81
3.2. The Arm's Length Standard	82
3.2.1. Legal Basis	82
3.2.2. Interpretation	86
3.3. Comparability Analysis	89
3.3.1. Delineating Transactions	89
3.3.2. Pricing	92
3.4. Transactional Adjustments	94
3.5. Conclusions	97
4. United States	99
4.1. Introduction	99
4.2. Regulatory History	100
4.2.1. Early Regulatory History (Pre-2005)	100
4.2.2. Recent Regulatory History (2005 Onwards)	103
4.3. Buy-in Payments	107
4.3.1. Introduction	107
4.3.2. Buy-in Royalties under Earlier Cost Sharing Regulations	107
4.3.3. Platform Contributions under Recent Cost Sharing Regulations	109
4.3.4. The Veritas Case	119
4.3.5. The Amazon Case	125
4.3.6. Author's Analysis	129
4.4. Stock-based Compensation Expenses	131
4.4.1. Introduction	131
4.4.2. The Xilinx Case	132
4.4.3. The 2003 Additions to the Cost Sharing Regulations and the Altera Case	138
4.4.4. Stock-based Compensation Expenses in the Amazon Case	141
4.4.5. Author's Analysis	141
4.5. Conclusions	143

5. OECD	145
5.1. Introduction	145
5.2. Activities	146
5.2.1. Development Activities and Services	146
5.2.2. Benefit Test	147
5.2.3. Excluded Activities	149
5.2.4. Centralized Services	153
5.3. Participants	153
5.3.1. Mutual Benefit	153
5.3.2. Substance	155
5.3.3. Controlled Non-Participants	165
5.4. Benefits	167
5.4.1. Identifying Benefits	167
5.4.2. Assigning Benefits	168
5.5. Contributions	170
5.5.1. Introduction	170
5.5.2. Identifying Contributions	170
5.5.3. Valuing Contributions	178
5.6. Balancing Payments	190
5.6.1. Introduction	190
5.6.2. Allocation Methods	191
5.6.3. Adjustments	192
5.6.4. Buy-in, Buy-out and Termination Payments	193
5.7. Conclusions	194
 6. European Union	 199
6.1. Introduction	199
6.2. Legal Status of the EUJTPF Report	199
6.3. Contents of the EUJTPF Report	200
6.3.1. Activities and Participants	200
6.3.2. Benefits and Contributions	201
6.3.3. Balancing Payments and Adjustments	203
6.4. Relevance of the EUJTPF Report	204
6.5. Conclusions	205

7. Documentation Requirements	207
7.1. Introduction	207
7.2. Burden of Proof	207
7.2.1. Who Should Prove What in Tax and Transfer Pricing Cases?	207
7.2.2. Penalties	211
7.3. OECD Documentation Guidance	211
7.3.1. The Three-Tiered Approach	211
7.3.2. The CCA Contract	213
7.4. PATA Documentation Guidance	215
7.5. EU Documentation Guidance	217
7.6. Proportionality	218
7.7. Conclusions	220

Part 3: International Tax Law **223**

8. Tax Treaty Qualification	225
8.1. Introduction	225
8.2. Permanent Establishments	226
8.3. Withholding Tax on Balancing Payments	231
8.3.1. Introduction	231
8.3.2. Tax Sharing	231
8.3.3. The General Concepts of Royalties and Services	233
8.3.4. Can Balancing Payments Qualify as Royalty Income?	236
8.3.5. Can Balancing Payments Qualify as Services Income?	241
8.3.6. Author's Analysis	246
8.4. Immovable Property	249
8.5. Conclusions	250
9. CFC Rules	253
9.1. Introduction	253
9.2. Background of CFC Rules	253
9.2.1. Balancing Export Neutrality and Competitiveness	253
9.2.2. Design and Compatibility with Tax Treaties	255
9.3. CFC Rules and CCAs	256
9.3.1. Introduction	256
9.3.2. Including Intangible Returns in CFC Income	257
9.3.3. Author's Analysis	261
9.4. Conclusions	262

10. Upfront Certainty and Dispute Resolution	265
10.1. Introduction	265
10.2. Upfront Certainty	265
10.2.1. Advance Pricing Agreements	265
10.2.2. Proposal for a Standard for APA Requests Concerning a CCA	268
10.2.3. Critical Assumptions	273
10.3. Dispute Resolution	275
10.3.1. Introduction	275
10.3.2. Disadvantages of Traditional Dispute Resolution Procedures	276
10.3.3. Proposal for Simultaneous or Multilateral Mutual Agreement Procedures	279
10.4. Conclusions	281
 Part 4: Conclusions	 283
 11. Conclusions and Recommendations	 285
11.1. Introduction	285
11.2. Historical Background	285
11.3. Legitimate Use and Tax Avoidance	287
11.4. US Cost Sharing Regulations vs. OECD Transfer Pricing Guidelines	288
11.5. An Arm's Length CCA	292
11.5.1. Step Plan	292
11.5.2. Model CCA Contract	295
11.6. Foreign Tax Liabilities	297
11.7. Potential Improvement of CFC Rules	299
11.8. Potential Improvement of Upfront Certainty and Dispute Resolution Procedures	300
11.9. The Future of CCAs after BEPS and US Tax Reform	301
 Annex – Model CCA Contract	 305
Bibliography	317
Official Publications	325
Case Law	329
Nederlandstalige Samenvatting	331
Curriculum Vitae	343

List of Abbreviations

AETH	Amazon Europe Technology Holdings SCS
ALS	Arm's Length Standard
AOD	Action on Decision
APA	Advance Pricing Agreement
ARR	Authority for Advance Rulings of New Delhi (India)
BEPS	Base Erosion and Profit Shifting
BIAC	Business and Industry Advisory Committee
CCA	Cost Contribution Arrangement
CFA	Cost Funding Arrangement
CFC	Controlled Foreign Corporation
CIDE	<i>Contribuição de Intervenção no Domínio Econômico</i> (Brazilian contribution for the intervention on the economic domain)
COFIN	<i>Contribuição para Financiamento da Seguridade Social</i> (Brazilian contribution for the financing of social security)
CSA	Cost Sharing Arrangement
CSR	Cost Sharing Regulations
CST	Cost Sharing Transaction
CUP	Comparable Uncontrolled Price
CUSP	Comparable Uncontrolled Service Price
CUT	Comparable Uncontrolled Transaction
ECJ	European Court of Justice
ECOSOC	United Nations Economic and Social Counsel
EU	European Union
EUJTPF	European Union Joint Transfer Pricing Forum
EUTPD	Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union
FDII	Foreign Derived Intangible Income
GILTI	Global Intangible Low Taxed Income
HR	House of Representatives (United States Congress) / Human Resources
HTVI	Hard to Value Intangible

IGS	Intra-group Services
IRS	Internal Revenue Service (United States tax authority)
IT	Information Technology
MAP	Mutual Agreement Procedure
MEMAP	OECD Manual on Effective Mutual Agreement Procedures
MNE	Multinational Enterprise
PIS	<i>Programa de Integração Social</i> (Brazilian social integration program)
R&D	Research & Development
OECD	Organization for Economic Cooperation and Development
OEM	Original Equipment Manufacturer
PATA	Pacific Association of Tax Administrations
PCT	Platform Contribution Transaction
PDP	PATA Documentation Package
PE	Permanent Establishment
RFB	<i>Receita Federal do Brasil</i> (Brazilian tax authority)
RPSM	Residual Profit Split Method
SEC	US Securities and Exchange Commission
SPV	Special Purpose Vehicle
TPG	Transfer Pricing Guidelines
UN	United Nations
US	United States
VAT	Value Added Tax

Preface

In my work as an in-house tax lawyer at a multinational company I have experienced at first-hand how complex it can be to design, implement and maintain a system for allocating the costs and benefits associated with more or less centralized activities. Generally the purpose of such exercise is to ensure tax deductibility in respect of costs and to avoid double taxation in respect of profits, while running a process that is practical enough to operate efficiently and transparent enough to explain to stakeholders. All of that not only requires a thorough understanding of the applicable tax rules and regulations, but also a deep insight in the business model of the company. To put it differently: It can offer a very interesting challenge!

Cost contribution arrangements or “CCAs” are a specific type of agreements that is often used for purposes of the above. They have so far received relatively limited academic attention, despite their apparent importance to every day fiscal practice. Over time that made me realize that they presented a great opportunity for a research project and I have not regretted selecting them as the topic for my PhD thesis ever since. This book is the result of that decision and my subsequent in-depth study into the tax treatment of CCAs. It examines how those arrangements relate to international transfer pricing standards, considers their position under international tax law and ultimately draws conclusions about the future for CCAs in a world that is more and more critical about the tax strategies of multinational enterprises.

Materials have been included up to 1 May 2018.

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Also there are my colleagues at AkzoNobel and Nouryon as well as all the finance professionals I met in the context of my work there, who discussed the topic of CCAs with me on countless occasions and thus helped me to develop my thinking about it. This further specifically includes my former colleague Hugo Vrij, who was prepared to read an early draft of my thesis from cover to cover and share useful comments and suggestions with me afterwards.

Especially warm gratitude goes out to my supervisor, Professor Gerard Meussen, for the invaluable guidance and advice that I received from him and, equally important, for the friendly way in which it was provided. I very much appreciated our cooperation, both at a professional and at a personal level!

Last but not least I would like to thank my wife, Mieke, for the patience and support throughout this project and my daughters, Fiene and Suze, for the inspiration to bring it to a good end.

Part 1: Introduction

1. Justification

1.1. Introduction

Over the last decades technological advancement and progressing globalization have (dramatically) changed the world economy. These developments have opened up many new markets and at the same time fundamentally changed the way in which multinational enterprises (“MNEs”) operate their businesses. Nowadays critical activities may take place online and MNEs might employ internationally organized, “*virtual*” teams of specialists, who can work together in digitalized environments from different locations across the world. There has also been a material impact on value chains, among others increasing the relevant importance of intangible assets like technology, know-how, brand names and trademarks.¹ Although these trends have clearly contributed to economic growth and global prosperity, they have also posed difficult to answer questions in the context of international tax law. It has become significantly more complex to determine how costs and business income are to be allocated among group companies. Meanwhile, MNE group companies will more often collaborate to jointly develop tangible or intangible assets or obtain services at their common expense and risk. As a part of this collaboration more or less centralized departments perform activities for the benefit of the group. Centers of expertise perform marketing and R&D activities that result in the group’s most valuable intangible assets, while shared service centers provide relevant support services in a wide range of areas, such as general management, accounting, legal, HR, IT etc. For tax purposes it will have to be established where the related costs are deductible and, perhaps even more importantly, where the additionally generated profit is subject to taxation. Much depends on the business model operated by the MNEs involved. Where the development of intangible assets is concerned, a group company performing most of the centralized marketing or R&D activities may for example come to own those assets. It can then license

1 The value chain is a set of activities that a company performs in order to deliver a valuable product or service for the market. The concept comes from business management and was first described by Michael Porter in 1985. See: Porter 1985.

them out to affiliates that use them in the course of their business in return for an appropriate royalty. When support services are provided, the group company providing these services could charge a businesslike service fee to the benefiting group companies. These scenarios imply a solution based on the recognition of segregated transactions covering individual activities. Alternatively, MNEs could choose a more holistic approach. Under certain conditions they could set up a framework agreement for any combination of joint activities that provides for an allocation of costs and risks among group companies proportionate to their relative share in anticipated benefits. Such framework agreements are referred to as cost contribution arrangements ("CCAs") or, in the United States, as cost sharing agreements ("CSAs") and they are the subject of this study.

1.2. Definition of a CCA

The OECD's Transfer Pricing Guidelines define a CCA as follows:

*"A CCA is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants."*²

The Transfer Pricing Guidelines then add to this:

*"In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement."*³

The United Nations' Transfer Pricing Manual on the other hand defines a CCA as *"an arrangement between enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The arrangement set out the responsibilities and risks of the participants and the nature and extent of the interest of each participant's assets, services or rights resulting from the arrangement"*.⁴

2 OECD Transfer Pricing Guidelines, Paragraph 8.3.

3 OECD Transfer Pricing Guidelines, Paragraph 8.5.

4 United Nations Practical Manual on Transfer Pricing for Developing Countries (2017), page 636.

In my own words a CCA is an arrangement under which the participating companies, generally members of the same multinational group, agree to jointly perform certain predefined activities aimed at collectively obtaining assets or services. The arrangement structures the collective ownership of the results of those activities and thus allows for the individual exploitation of those results by participants. It allocates the costs and risks associated with the activities performed among participants in proportion to their expected benefits from such exploitation.

A CCA can be open ended, if cost shared activities are performed continuously, or it can have a fixed term, if the activities are performed on a project basis. However it generally does not involve an individually defined and ring-fenced request by a principal to a service provider. As a consequence the associated costs and risks can theoretically be regarded the own costs of the CCA participants. Similarly the results will be their collective effective ownership right from the very moment that they come to exist. That implies that participants have unrestricted access to any intangibles that might be developed under the CCA and they can exploit them without having to make any further compensation payments to other co-developers. In a US context Shea and Lewis have worded this fundamental aspect of a CCA follows:

“The principle US tax feature of such an arrangement is that, once the property is developed, its subsequent use by participating group members without charge will not result in reallocations of income...”⁵

This unrestricted, unburdened access to cost shared results guarantees a free-flow of knowledge and expertise throughout the group and therefore allows for a legal structuring of activities that is well aligned with how many MNEs prefer to organize their operations. At the same time it can also reduce administrative complexity. These and other legitimate, non-fiscal benefits from operating a CCA are further discussed in Paragraph 2.3.1.

1.3. Example

The difference between an exchange of services, licensing arrangement and a CCA can be illustrated by the following example:

The fictitious company X Electronics (“X”) is a multinational group that manufactures and sells consumer electronics. Its parent company is located

5 Shea and Lewis, The Tax Executive 1987, page 357 – 363.

in the United States (X US). The group has further established a number of manufacturing plants at logistically strategic locations and has local distribution subsidiaries in every country where it sells its products. Manufacturing and sales are considered the group's primary business activities. Next to that X US takes care of the group's executive management. The group's global R&D center is located in Singapore (X Singapore), while X UK coordinates the group's strategic marketing activities and operates a shared service center (SSC) that renders financial, legal and administrative support services to the other group companies.

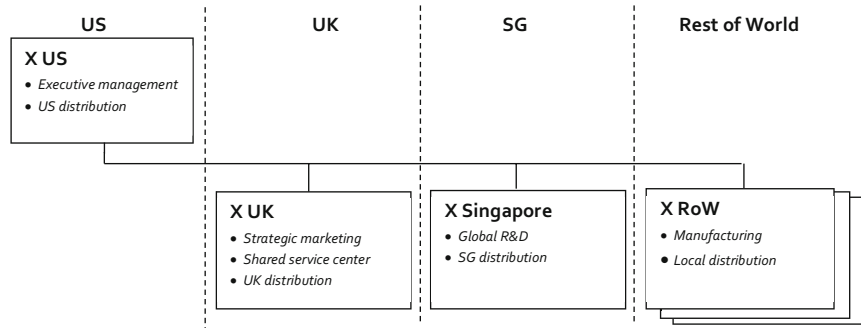


Figure 1: "X Electronics Business Model"

Each of the group companies employs sufficiently qualified personnel to service its own national market and to independently manage its own operations. Manufacturers contribute to the group's joint R&D effort, for example by sharing experiences with the implementation of new technology or by providing data on process efficiencies. In a comparable way the distributors facilitate the group's joint marketing effort, for example by performing market analysis and testing the effect of global marketing strategies. Under a first possible business model X Electronics would fully segregate all individual intercompany transactions. In this scenario X Singapore and X UK could be appointed principal companies for R&D and strategic marketing respectively. They could coordinate the associated activities and would have to appropriately compensate the other group companies for their contribution to the development and maintenance of intangible assets. In return they would become the full effective owners of the R&D and marketing intangibles. X Singapore could then provide a royalty bearing license in respect of R&D intangibles to the group's manufacturers, while X UK could

provide a royalty bearing license in respect of the marketing intangibles to the group's distributors. Furthermore, X US and X UK would enter into separate service level agreements with all group companies and charge them a businesslike service fee taking into account their benefit from executive management and support services.

As an alternative the group could opt to structure the global R&D, strategic marketing, executive management and support services in a CCA. In that case all the group companies performing primary business activities would participate in a single, multilateral framework agreement, thus limiting the number of intragroup contracts. They would become the collective owners of the R&D and marketing intangibles developed as well as the services rendered. As a consequence the group companies would have unrestricted access to those assets and services and could freely exploit them in the course of their own business. They would be allocated a proportionate part of the costs and risks associated with all joint activities in proportion to their expected benefits. This could be settled through so called balancing payments under a netting system that credits or debits group companies for the difference between costs incurred and the costs allocated, thus minimizing the number and size of intragroup payments.

It is important to note that in both scenarios the intercompany transactions will determine to a large extent how the group's overall taxable profit is divided up among the different group companies. At the same time the qualification of those intercompany transactions for purposes of international tax law will determine in which country or countries the group companies have to pay tax on their part of the profit. Specifically the allocation of ownership of R&D and marketing intangibles can have a material impact on the group's overall tax burden. If these intangibles are developed and owned by X Singapore and X UK, a substantial part of the group's profit will be transferred to those companies through royalty payments. If on the other hand the intangibles are jointly developed and co-owned under a CCA, the profit allocation will depend on the terms and conditions of that arrangement.

1.4. Relevance of Research

1.4.1. Cost deductibility and Effective Ownership of Intangible Assets

International cooperation between group companies offers synergy benefits and economies of scale. However, it also results in a fiscal challenge, when it

comes to appropriately allocating to those group companies the costs associated with the jointly performed activities. Benshalom worded this as follows:

*"As business structures, MNEs flourish in those industries where the ability to operate an integrated business in numerous jurisdictions enables them to internalize efficiently a diversity of the group's (collective) costs – such as transaction costs, research and development costs, information obtaining costs and management costs. Hence, tax authorities find it difficult to directly assign MNEs' collective costs and profits to any specific corporate entity operating in a certain jurisdiction. This difficulty is particularly high with regard to horizontally integrated MNEs in which entities operating in different jurisdictions simultaneously utilize the same pool of resources to generate value."*⁶

Tax authorities are not the only ones concerned. For MNEs themselves it is also crucial that they are able to share costs in a consistent and defensible manner. If cost reallocations are not accepted and the costs are not tax deductible, then that obviously affects their net results significantly. On the other hand a cumbersome administrative system of internal cost reallocation is inefficient and too expensive and would hurt their competitive position. Hoping to strike the right balance between these two considerations the MNE might opt for a CCA. This can have fiscal consequences beyond the allocation of costs, because it also outlines to what extent the participating group companies are entitled to the benefits from the joint activities. Quite relevantly the terms and conditions of the CCA will determine which group companies become the effective owner of centrally developed tangible and intangible assets. Specifically ownership of intangibles is becoming ever more important, as research has shown that in the modern economy the relative contribution of intangibles to business profits has increased strongly. Shapiro and Pham for example have compared intangible intensive sectors to other industries looking at the value created per employee, the wages earned per employee and the development of the number of jobs. The results led them to conclude that *"IP-intensive areas of manufacturing produce relatively much larger benefits, with the most IP-intensive industry, pharmaceuticals and biopharmaceuticals, generating the greatest such benefits"*.⁷ The trend is further confirmed by the results from an annual study performed by investment banking firm Ocean Tomo, which considers the market value of S&P 500 companies in comparison to the book value of their tangible assets

6 Benshalom, Virginia Tax Review 2007/3.

7 Shapiro and Pham 2007.

while attributing the remainder to intangibles. Where intangibles represented approximately 17% of the market value of the considered companies in 1975, they accounted for approximately 84% of that value in 2015.⁸ Accepting the increased importance of intangibles for the value chain of multinationals implies that their effective ownership becomes a critical element determining in which jurisdiction a major part of the business profits is taxable. This makes a good understanding of the fiscal merits of the arrangements under which they are developed of crucial importance. Those arrangements could very well be CCAs.

1.4.2. Base Erosion and Profit Shifting

Further need for research into the tax aspects of CCAs is triggered by the recent concerns about their use in tax avoidance structures. Over the last years there has been much to do about the tax strategies of MNEs. The key concern is that the international orientation of MNEs places them in a position to minimize their tax charge at the expense of governments as well as the taxpaying man in the street. Stakeholders in this debate include politicians, non-governmental organizations, lobby groups, action committees, tax administrations, other taxpayers and, of course, MNEs themselves. More and more it has become clear to all of them that inadequate tax and transfer pricing rules are a substantial part of the problem. Tax professionals understand that the pricing of intercompany transactions is an abstract exercise rather than an exact science and that tax administrations will always be faced with a natural information disadvantage. Nevertheless, in the main stream media as well as the political arena the understanding of the topic is limited. As a consequence, among journalists and politicians many oversimplified and populist arguments have been made, without the real bottlenecks being identified or practical measures being proposed. Over time however more serious international policymakers have also acknowledged the problem. This has led to various international initiatives at different levels. The European Commission issued an *“Action plan to strengthen the fight against tax fraud and tax evasion”*⁹ and a *“Recommendation regarding measures intended to encourage Third Countries to apply minimum standards of good governance in tax matters”*¹⁰. The Commission set up a *“Platform for Tax Good Governance”* to monitor the progress made by Member States in this context, while the European Parliament issued a *“Report on the Fight against Tax Fraud, Tax Evasion and*

8 Ocean Tomo 2015.

9 European Commission, Action plan to strengthen the fight against tax fraud and tax evasion, 6 December 2012, COM(2012)722.

10 European Commission, Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters, 6 December 2012, OJ 338/37.

Tax Havens” calling on Member States to half the uncollected tax gap calculated at € 1 trillion by 2020.¹¹ Furthermore, on 20 June 2016 the EU’s Economic and Financial Affairs Council adopted an anti-tax avoidance package, the core of which consists of a directive requiring EU Member States to implement a wide range of anti-avoidance measures in their national law systems.¹²

The EU’s actions build on the measures agreed by OECD Member States and a number of other countries in the fall of 2015 under the so called BEPS project. This project was initiated three years earlier by the G20 Ministers of Finance at a 2012 meeting in Mexico with the intention to strengthen the international standards for corporate tax regimes. In early 2013 the OECD’s first publication under the project was a Base Analysis Report on base erosion and profit shifting, which from that point on was also referred to as “*BEPS*”.¹³ This Report identified the key principles underlying taxation of cross-border activities that offer tax avoidance opportunities and recognized that under certain circumstances CCAs can be part of the problem. The most aggressive taxpayers might use a CCA to allocate the effective ownership of newly developed intangibles to so called cash box entities located in tax havens. These entities pay part of development costs, but do not themselves perform any development activities nor house any expertise that would be required to do so.¹⁴ Four detailed examples of how CCAs may be applied in tax avoidance structures are considered in Paragraph 2.3.2. The OECD’s Base Analysis Report continued to conclude that a comprehensive Action Plan was needed to provide countries with instruments aimed at better aligning taxing rights with real economic activity. This Action Plan was presented by the OECD five months later.¹⁵ Among others it included an action to develop rules that better ensure that profits are taxed where value is created.¹⁶ Following through on the different action points related to this topic the final reports published in September 2015 included an overall revision of the relevant parts of the Transfer Pricing Guidelines, including Chapter VI on intangibles and Chapter VIII on CCAs.¹⁷ As will be discussed in Chapter 5, these revisions fundamentally impact the position of CCAs in every day fiscal practice.

11 European Parliament, Report on the Fight against Tax Fraud, Tax Evasion and Tax Havens (2013/2060 INI), 21 May 2013, OJ C55/7.

12 European Council, Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, 12 July 2016, OJ L193/1.

13 OECD, “*Addressing Base Erosion and Profit Shifting*”, 12 February 2013.

14 Annex C to the OECD’s Base Analysis Report includes two examples of tax planning structures involving the transfer of intangibles under a CCA.

15 OECD, “*Action Plan on Base Erosion and Profit Shifting*”, 19 July 2013.

16 Actions 8 – 10 of the OECD Action Plan.

17 OECD/G20 Base Erosion and Profit Shifting Project, “*Aligning Transfer Pricing Outcomes with Value Creation*”, 5 October 2015.

1.5. Purpose of Research

1.5.1. Research Objectives

Obviously intangibles have specific characteristics that distinguish them from other business assets. They are relatively mobile and easy to reallocate. At the same time they can be difficult to identify and value. Some MNEs consider these characteristics a tax planning opportunity and actively pursue attributing substantial profits to intangibles located in low tax jurisdiction. Others will regard the complexity and the possible disagreements with tax authorities a difficult to manage risk of double taxation. This was confirmed when Walpole and Riedel in 2014 conducted 20 interviews with tax professionals at companies listed on the London Stock Exchange to gain insight into the extent to which tax is a motivator for MNEs to decide where to develop and ultimately locate valuable intangibles. They reported their findings in a working paper, in which they concluded that in some cases “*multinational corporations deal with tax at the highest levels of management and tax transfer pricing involving IP is a ‘main-stream’ activity*”, while in other cases “*the tax group is left to deal with the tax implications of commercial decisions that are taken by others*”.¹⁸ In both instances MNEs might use a CCA for the development of intangibles, albeit with different intentions. In my opinion this divide should be taken into account, when rules determining the tax and transfer pricing treatment of CCAs are designed or applied in practice. While the BEPS initiatives have shown that there is a common consensus that tax avoidance has to be called to a halt, this should not be achieved at the expense of bona fide taxpayers. Taking that into consideration the research objectives of this study are as follows:

- (i) To examine the historical background and original purpose of CCAs and to establish how the conceptual thinking about these arrangements as a legitimate transfer pricing instrument and a tax avoidance tool evolved over the years;
- (ii) To identify the legitimate business reasons for the use of CCAs, to determine the role of these arrangements in tax avoidance structures and to propose a categorization model that can facilitate a tax and transfer pricing analysis of their application in practice;

¹⁸ Walpole and Riedel 2014.

- (iii) To analyze and compare the applicable transfer pricing rules and regulations governing CCAs as well as relevant case law, focusing primarily on the US Cost Sharing Regulations and OECD Transfer Pricing Guidelines;
- (iv) To develop a step plan and a model legal contract facilitating the implementation of an arm's length CCA;
- (v) To examine the position of CCAs under international tax law and to determine when this may result in a foreign tax liability of the CCA participants taking into account the qualification of the arrangement under tax treaties;
- (vi) To consider how anti-abuse rules aimed at including income of controlled foreign corporations in the taxable base of their domestic parent ("*CFC rules*") can be improved so that they more effectively counter the use of CCAs in tax avoidance structures;
- (vii) To propose improvements to procedures for obtaining upfront certainty as well as for dispute resolution aimed at increasing their effectiveness in situations involving a CCA.

I will seek to answer these questions from an objective, legal dogmatic perspective. This should allow for a critical analysis from inside the juridical system itself, of those elements that have proven to cause uncertainty and disputes in everyday fiscal practice. Where appropriate, I will accompany my findings by concrete recommendations for improvement.

1.5.2. Limitations of Scope

My research is intended as a contribution to the conceptual thinking, both in an academic setting and in every day fiscal practice, about a very specific type of legal arrangement that is generally concluded by companies that are members of the same multinational group. It is not intended to provide an exhaustive analysis of each and every possible tax and transfer pricing aspect of CCAs. Instead I have focused on the most common issues from a transfer pricing and international tax law perspective. There are three limitations of the overall scope that deserve explicit mention.

First, my research accepts and stays within the borders of the existing international framework of transfer pricing and international tax law. Such framework assumes that companies belonging to the same multinational group are to be taxed separately and that in determining their individual taxable income

intercompany transactions among these companies should take place under arm's length terms and conditions, i.e. under terms and conditions that under similar circumstances would also have been agreed among unrelated parties. The background and merits of this so called arm's length standard as well as a substantiation of its status as a commonly accepted standard of international tax law will be further discussed in Chapter 3. Here it should however already be mentioned that, while this study in the context of the foregoing remark will include recommendations for improvement of the existing legal framework, it will not endeavor to propose radically innovative alternatives. As a consequence, I have for example not investigated the possibility to allocate income from intangible assets among group companies using a formula based approach or the possibility to completely de-fiscalize such income.

Second, I will not discuss exhaustively the issues related to valuations of intangible property. Such valuations belong more to the area of expertise of economists than to that of lawyers. Nevertheless, they can be crucial to determining taxable income and, by consequence, they are the frequent subject of disputes between taxpayers and tax administrations. As such, also tax lawyers cannot disregard the complexities of these valuation exercises altogether. Therefore, I will discuss the most relevance guidance provided in the US Cost Sharing Regulations and OECD Transfer Pricing Guidelines and consider its reasonableness and effectiveness in the context of CCAs.

Third, I will not discuss indirect tax aspects in my thesis. The most obvious of these is of course the treatment of payments under a CCA for purposes of value added tax ("VAT"), or similar indirect taxation. Generally, these payments should be considered a consideration for a service and, hence, can be subject to such taxation. However, the next question is then what specific rules apply, among others in respect of the place of supply of this service. In a European context under strict conditions a specific so called cost sharing exemption can apply, if an entity that is a member of an independent group of persons renders to the other group members services that are directly necessary for carrying out an activity that is exempt from VAT or an activity in relation to which the group members are not taxable persons.¹⁹ This exemption is particularly relevant for exempt companies, as they would not be able to claim a deduction for input VAT, if that would be imposed. The workings of the exemption are not undisputed and have recently been the subject of different cases brought before the European Court of Justice ("ECJ").²⁰ In those cases the Advocate General and then the ECJ concluded that the exemption was to be applied only very restric-

19 EU Council Directive 2006/112/EC on the common system for value added tax, Article 132(1)(f).

20 ECJ C-326/15, "*DNB Banka*", 21 September 2017 and ECJ C-605/15 "*Aviva*", 21 September 2017.

tively. These decisions were received critically in fiscal literature.²¹ However, it should be noted that the cost sharing exemption in the VAT Directive is intended to accommodate very specific persons (those belonging to a group engaging in exempt activities), while it pertains to arrangements that may be similar to the CCAs that are the topic of my research, but are not necessarily identical. For one, the cost sharing exemption in the VAT Directive also appears to apply to designated service providers that do not themselves expect a benefit from the services other than a consideration in cash, while under CCAs all participants are required to expect a benefit that they will individually exploit (see Paragraph 5.3.1). In other words the cost sharing exemption in the VAT Directive targets a broader group of agreements, but a more specific group of taxpayers. With that acknowledged, indirect tax matters are left outside the scope of my research and will therefore not be further discussed hereafter.

1.6. Methods and Materials

1.6.1. Methodology

Any properly designed investigation into the tax treatment of CCAs will be of a multidisciplinary nature. Especially in respect of the transfer pricing aspects the topic has to be addressed from both the legal and economic perspective to accurately determine its position under both substantive and formal tax law. First an insight in the legal consequences of the arrangements will have to be obtained. Key questions in this respect are related to the legal allocation of costs, risks and ownership of proceeds associated with the joint activities performed under the arrangements. Subsequently the economic impact of this allocation has to be established. Only after all relevant characteristics of the situation have been economically analyzed and the relative value of contributions, risks and benefits for each of the participants is reasonably clear, will it be possible to conclude whether the CCA has an acceptable outcome from a transfer pricing perspective. Subsequently the qualification under tax treaties and the treatment from an international tax law perspective have to be determined. And in parallel to all of this, it can be necessary to consider how procedural fiscal law divides the burden of proof between taxpayer and tax authorities and provides means to obtain advance certainty or settle disputes.

Notwithstanding the relevance of the economic analysis, this study primarily adopts the traditional legal dogmatic approach. Economic aspects are addressed always in the context of their impact on the legal system. It is recognized that

21 Wolf, *International VAT Monitor* 2017/3 and Amand, *International VAT Monitor* 2017/6.

CCAs are a specific type of arrangements with unique legal and fiscal consequences. The following chapters aim to provide a comprehensive overview and analysis of the most important rules and regulations governing these arrangements. It is investigated how these rules and regulations interact and construe a system that foresees in a consistent tax and transfer pricing treatment of CCAs. This study is performed from an internal legal perspective allowing for firstly a normative analysis of the present law system and secondly proposals for clarification and improvements thereof.

1.6.2. Sources of information

Over the years various international organizations have published guidance on transfer pricing and the tax treatment of CCAs. Most notably this includes the Organization for Economic Co-operation and Development ("OECD"). Established in 1961 the Paris based OECD today counts 34 member countries, has a budget of approximately € 350 million and employs a secretariat staff of approximately 2,500. It aims to promote policies that improve the economic and social well-being of people around the world. Its Committee on Fiscal Affairs provides a forum in which government representatives can work together, share experiences and seek solutions to common problems. In 1979 the Committee published a report entitled "*Transfer Pricing and Multinational Enterprises*".²² This included guidance on the appropriate tax treatment of CCAs. It was supplemented in 1984 by a second report entitled "*Transfer Pricing and Multinational Enterprises – Three Taxation Issues*".²³ In 1995 the Committee revised its position by publication of the "*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*" (hereafter also referred to as "*the OECD Transfer Pricing Guidelines*" and "*the Transfer Pricing Guidelines*").²⁴ These guidelines were later supplemented by separate chapters on intangible property, services, CCAs and the transfer pricing aspects of business restructurings as well as various annexes. The Committee on Fiscal Affairs renders a continuous effort to keep the guidelines up to date and improve them where possible.

Parallel to the OECD's efforts, the United Nations' Economic and Social Counsel since 1968 has had a group of tax experts working to enhance and promote international tax cooperation. This group focuses on developing countries and countries with economies in transition. In 2004 ECOSOC renamed the group Committee of Experts on International Cooperation in Tax Matters. The Committee's "*Transfer Pricing Practical Manual for Developing Countries*" intends

22 OECD, "*Transfer Pricing and Multinational Enterprises*", 1979.

23 OECD, "*Transfer Pricing and Multinational Enterprises – Three Taxation Issues*", 1984.

24 OECD, "*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*", 1995.

to provide developing countries with clearer guidance on the interpretation and application of transfer pricing standards. It should assist both tax authorities and taxpayers and also specifically addresses the topic of CCAs.

Meanwhile the European Union has set up the EU Joint Transfer Pricing Forum ("EUJTPF") to assist and advise the European Commission in respect of transfer pricing tax matters. It operates within the framework of the OECD's Transfer Pricing Guidelines and aims to propose to the Commission pragmatic, non-legislative solutions to transfer pricing issues. The EUJTPF consists of representatives from each EU Member State as well as experts from the private sector and an independent chairman. It was set up and first met in 2002, although its position was only formally confirmed in 2006.²⁵ The EUJTPF has divided its work into activities related to the EU Arbitration Convention and activities related to other transfer pricing issues. So far its efforts have among others resulted in a Code of Conduct on the Implementation of the Arbitration Convention²⁶, a Code of Conduct on Transfer Pricing Documentation²⁷, guidelines on Advanced Pricing Agreements²⁸ and guidelines on low-value-adding intragroup services²⁹. Furthermore, the 2011-2015 EUJTPF Work Program announced *"an intention to explore the possible scope and degree to which a common approach to CCAs could be developed within the EU"*. In order not to duplicate or interfere with the ongoing OECD's work on the transfer pricing aspects of intangibles, the EUJTPF focused on services not creating intangibles. This resulted in the *"Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP)"* published on 7 June 2012. It was adopted by the European Commission in its communication of 19 September 2012.³⁰

In addition to the European efforts the tax authorities of the United States, Canada, Japan and Australia united in the Pacific Organization of Tax Administrators ('PATA') published guidelines on bilateral Advanced Pricing Agreements

25 European Commission, Decision setting up an expert group on transfer pricing, 22 December 2006, OJ L32/189.

26 Revised Code of Conduct for the effective implementation of the Arbitration Convention, 30 December 2009, OJ C322/1.

27 European Council, Resolution on a code of conduct on transfer pricing documentation for associated enterprises in the EU, 28 July 2006, OJ C176/1 ("EUTPD").

28 European Commission, Report on the work of the JTPF in the field of dispute avoidance and resolution procedures and on APAs in the EU, 26 February 2007, COM(2007)71.

29 European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals 1. Guidelines on low value adding intra-group services and 2. Potential approaches to non-EU triangular cases, 25 January 2011, COM(2011)16.

30 European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period July 2010 to June 2012 and related proposals 1. Report on Small and Medium Enterprises and Transfer Pricing and 2. Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP), 19 September 2012, COM(2012)516.

and Mutual Agreement Procedures. Furthermore the PATA has provided standards under which taxpayers can create uniform transfer pricing documentation. Inter alia the “*PATA Documentation Package*” includes detailed instructions on how to document a CCA.³¹

Next to the materials from the above mentioned intergovernmental organizations, there are various other sources of information taken into account in this research. This includes the national tax law of many different countries, regulations published by tax administrations, tax treaties, case law and a wide range of academic publications.³² Most notably quite detailed guidance is outlined in the Cost Sharing Regulations published by the US Treasury and IRS under Section 482 of the Internal Revenue Code, which regulations were updated several times over the years. Furthermore, it also deserves to be explicitly mentioned that some interesting considerations can be found in Indian case law, which traditionally is very instructive and can provide for an interesting, alternative, non-Western view on tax matters.³³

1.7. Contents

This study is made up of four parts:

- **Part 1 is an introduction on the topic of CCAs.** It is made up of two chapters. This Chapter 1 provides for a scientific justification for the research. It explains the purpose and methodology of the research and outlines its structure. Chapter 2 evidences the concept of a CCA as an established instrument for intragroup cooperation. Going back to the origin of this concept it can be determined with what purpose tax legislators first introduced these arrangements as a transfer pricing instrument for MNEs. Furthermore, this chapter aims to give a better insight in the application of CCAs in fiscal practice for both legitimate purposes and in tax avoidance structures. To facilitate distinguishing between both types of use, I will present a categorization method that helps to better understand the taxpayer’s motives for concluding a CCA.
- **Part 2 examines the transfer pricing aspects of CCAs.** Consisting of five chapters this part focusses on the relevant OECD guidance and the applicable US rules, laid down in the OECD Transfer Pricing Guidelines and the US

³¹ PATA Transfer Pricing Documentation Package, 12 March 2003, IR-2003-32.

³² For a comprehensive list of all consulted publications see the attached bibliography.

³³ A list of official publications and case law is also attached.

Cost Sharing Regulations. Before those are addressed, Chapter 3 provides some relevant general transfer pricing considerations. It discusses the legal status and further interpretation of the international standard for setting intercompany prices, the so called arm's length standard, and considers some general aspects of its application in general as well as in situations involving CCAs specifically. Chapter 4 provides additional historical background on the US Cost Sharing Regulations and looks at the two most disputed cost sharing issues in the United States: buy-in payments and the sharing of stock-based compensation expenses. Chapter 5 then discusses the guidance from Chapter VIII of the OECD Transfer Pricing Guidelines. The analysis is structured around five main focus areas to also give the reader a better insight in what a CCA is and how it works. Among others the substance requirements imposed on participants will be addressed. Those requirements are decisive for the access of cash box entities to CCAs and therefore determine the effectiveness of use in tax avoidance structures. A second crucial aspect to be discussed is the valuation of contributions. Should they be valued at cost or at market price and, if the latter is true, then how should such market price be determined? Although an exhaustive analysis of valuation techniques is not intended, the most relevant valuation issues are addressed. This includes the valuation of contributions that consist of making pre-existing intangible assets available, contributions that consist of providing cost shared services or development activities and contributions that merely encompass the passive funding of cost shared activities. Next Chapter 6 discusses the EUJTPF's fairly modest contribution to the debate consisting of its Report on services CCAs not resulting in the creation of intangible property. Finally, Chapter 7 completes the transfer pricing part of this study by outlining formal aspects. It features general remarks about the division of the burden of proof in transfer pricing matters and considers the documentation requirements imposed on taxpayers.

- **Part 3 analyzes the treatment of CCAs under international tax law.** This part is made up of three chapters. First Chapter 8 looks at the tax treaty qualification of CCAs and the situations in which a participation in a CCA can cause a foreign tax liability. Can it for example cause a participant to have a foreign permanent establishment or can balancing payments be subject to source state withholding tax? Chapter 9 subsequently discusses the potential role of CFC rules in the fight against tax avoidance structures, while Chapter 10 critically reviews the existing possibilities to obtain upfront certainty from tax administrations about the tax treatment of CCAs as well

as the procedures for dispute resolution and suggests some improvements to those processes.

- **Part 4 summarizes conclusions and recommendations.** This part is comprised of only one chapter, Chapter 11, which reflects on the most relevant findings of the research. It features a comparison between the US Cost Sharing Regulations and the OECD Transfer Pricing Guidelines and then provides an example of a valid arm's length CCA contract as well as a step plan for its implementation. It also summarizes the recommendations for improvements to various rules of international law that are crucial to the tax treatment of CCAs and verifies their effectiveness.

2. Concept and Use

2.1. Introduction

MNEs are continuously trying to realize the most efficient organizational structure. There is a constant search for the optimal level of centralization or decentralization of various business functions. How successful the MNE is, will determine to what extent it can realize economies of scale and benefits of integration. For example, a centrally led purchasing function can result in better buying power, a reduction of management layers may lead to stronger and more cost efficient management, optimally organized financing reduces the group's cost of capital, more or less decentralized marketing can expand the company's advertorial scope and joint R&D could prove the best way to guarantee a valuable bundling of know-how and technology. However, it has since long been recognized that synergies should not necessarily be considered the Holy Grail in the quest for efficiency optimization.³⁴ Instead striking the right balance between centralization and local responsibility should be the goal. The efforts to achieve this will not stop at country borders. By consequence, there will be many differing examples of more or less centralized activities being performed for the benefit of multiple group companies in more than one country. This can include both open ended joint efforts as well as project-based initiatives. For tax purposes the costs, risks and benefits related to these activities should be appropriately allocated among the different group companies. As explained in the previous chapter, CCAs offer a framework for this allocation, consisting of an upfront sharing of costs and risks and a subsequent individual exploitation of results by participants.

Before the rules and regulations governing CCAs are subjected to a looking glass examination in the following chapters, this Chapter 2 considers the origin of the CCA concept and how it is applied in fiscal practice. It first examines the difference between joint development agreements concluded among third parties and CCAs concluded among companies belonging to the same multina-

34 See for example Goold and Campbell, Harvard Business Review 1998/5.

tional group (Paragraph 2.2.1 and 2.2.2). Subsequently a historical overview is provided of the most relevant regulatory publications that evidence how CCAs have over the years been recognized as an established instrument for the fiscal structuring of intragroup collaboration. Going back to its origin will make clear how the concept of “*a bona fide CSA*” was first introduced by the US Treasury and IRS as a safe haven for taxpayers to avoid complicated valuations of intangible assets. The conceptual analysis is completed by an examination of the legal status of these arrangements, addressing whether they can be qualified as a joint venture or partnership and what consequences that has for participants (Paragraph 2.2.3). Next, four legitimate reasons for using CCAs are identified (Paragraph 2.3.1). These more “*noble*” motives for use are contrasted by four examples of application in tax avoidance structures (Paragraph 2.3.2). Insights from these discussions are then translated into a proposal for a theoretical framework to categorize so called development CCAs, i.e. arrangements that lead to the creation of intangible assets, depending on what type of intangible assets are developed and the level of centralization of the cost shared activities (Paragraph 2.3.3). Finally the conclusions that can be drawn from all of the above are summarized in a closing paragraph (Paragraph 2.4).

2.2. The CCA Concept

2.2.1. Uncontrolled Joint Development Arrangements

Before setting out to further examine the concept and use of CCAs as a structure for cooperation between companies that are members of the same multinational group, it has to be established that the terms and conditions of intercompany CCAs generally differ from those of similar arrangements between unrelated parties. This is specifically true in respect of agreements aimed at the joint development of valuable intangible property. That has also been confirmed by the United States Treasury and IRS, although it did take them some time to get there, as their thinking about the issue evolved over the years. In 1988 they published a so called White Paper on transfer pricing under Section 482 of the US Revenue Code, in which it was argued that “*CSAs have long existed at arm’s length conditions between unrelated parties*”.³⁵ At the same time both government bodies admitted to have little experience with controlled as well as uncontrolled CSAs and they therefore welcomed receiving information from taxpayers regarding their contractual arrangements and experience with

35 Treasury and IRS, “*A Study of Intercompany Pricing under Section 482 of the Code*”, 18 October 1988, Notice 88-123 (1988-2 C.B. 458) (“*White Paper*”)

cost sharing. However, the comment letters and other information received in response provided only limited examples of uncontrolled joint development arrangements similar to intragroup CSAs. That caused a change in the opinion about the existence of CSAs among unrelated parties. In fact, by the time they proposed new regulations in 2005 the Treasury and IRS expressed the view that there was a fundamental difference between intercompany CSAs and uncontrolled joint development arrangements. This was complemented by the observation that unrelated parties generally agree to jointly exploit the results of their cooperation, whereas related parties will allow for individual exploitation by each of the CSA participants. Furthermore, it was acknowledged that unrelated parties commonly share benefits based on their respective cost contributions, while related parties structure this the other way around sharing costs based on their anticipated benefits. By consequence, joint development agreements between unrelated parties according to the Treasury and IRS typically involve “*a materially different division of costs, risks and benefits than in CSAs under the regulations*”.³⁶ However, as will be explained below, that does not mean related parties CCAs and CSAs cannot be businesslike and also, as will be explained in Paragraph 3.4, that does not mean that they by definition conflict with the arm’s length standard.

When the OECD issued a public discussion draft on the revision of Chapter VIII on CCAs of the Transfer Pricing Guidelines in 2015, the comments received again did not provide convincing evidence of joint development arrangements between unrelated parties resembling intragroup CCAs. In fact most of the respondents did not address the possible existence of third party arrangements at all. An exception to this rule was the letter sent in by the Business and Industry Advisory Committee (BIAC), generally considered as the voice of business at the OECD.³⁷ This letter discussed a number of examples of uncontrolled development arrangements between third parties from among others the oil and gas, aerospace, entertainment, biotech and pharmaceutical industries. In an appendix there was also a text included from an agreement extracted from public filings with the United States Securities and Exchange Commission (“SEC”). However, most of the examples did not provide insight in the most critical elements, i.e. those that determined how participants shared costs, risks and benefits. Some seemed to concern a shared service agreement or a financing structure rather than a joint development arrangement. The more

36 Treasury and IRS, 2005 Proposed Cost Sharing Regulations, 70 Fed Reg 51116 (2005), preamble.

37 Business and Industry Advisory Committee (BIAC), Commentary to the OECD’s Public Discussion Draft “*BEPS Action 8: Revisions to Chapter VIII of The Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)*”, 29 May 2015.

detailed example in the appendix however did indeed have the characteristics of the latter type of arrangement. It also involved a certain level of individual exploitation of the cost shared results by its participants. Nevertheless, this was limited to the *operational* exploitation of results only. The profit or loss from this exploitation was subsequently shared by participants in the same ratio in which they had contributed to development costs. The *financial* exploitation of results was therefore still for the joint account and benefit of participants. By consequence, the arrangement still differed from a CCA, at the very least in this one critical way.

The tendency between third parties to choose for joint exploitation of results and the sharing of the benefit in proportion to cost contributions instead of the other way around is something I also recognize from my own experience in practice. It is important to acknowledge that this is not caused by a non-businesslike nature of intercompany CCAs, but rather by a material difference in the position of related and unrelated parties. First of all the latter group will prefer a joint exploitation of results, because that limits the risk of ending up in mutual competition when individually commercializing those results. Furthermore, it has to be considered that unrelated parties will have only limited information about each other's business. That knowledge gap will be further deepened by the fact that unrelated parties are likely to look for a partner that operates in a different territory or a different industry instead of collaborating with their direct competitors in the same market. Once they have found such partner they may still not be willing to disclose all details of their business operations to it. By consequence, the partners can lack insight in relevant facts and circumstances affecting each other's commercial position. This can make it difficult or even impossible for them to determine each other's potential benefits from a contemplated project, something that they would have to do in case they would enter into a CCA that provides for the anticipated benefits to serve as a method for the allocation of costs. For affiliated companies on the other hand the situation is quite different. They will be less concerned about potential competition issues and they will be significantly more knowledgeable about each other's business operations. Under these circumstances it can be a rational business decision to enter into a cooperative structure based on individual exploitation of results and a sharing of costs based on anticipated benefits. As we will see in Paragraph 3.4, this is a crucial condition for the recognition of a CCA as an acceptable arrangement for intercompany cooperation from a transfer pricing perspective, even when they are not commonly found between unrelated parties.

2.2.2. Controlled Joint Development Agreements

2.2.2.1. The 1968 US Transfer Pricing Regulations

Acknowledging that the CCAs that are the subject of this study are arrangements found mostly between related parties enables a more focused investigation into the origin of their concept. This logically goes back to 1966, when the United States were the first country in the world to propose transfer pricing regulations that included specific language and several explanatory examples on CSAs, referred to at the time as “*bona fide cost sharing arrangements*”.³⁸ The proposed regulations were replaced by final regulations in 1968 that provided for much more condensed guidance, but still addressed the topic and, in general, continued the earlier proposed approach.³⁹ These regulations defined a bona fide cost sharing arrangement as “*an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced*”. For such arrangement to qualify as bona fide it had to “*reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm’s length basis*”.⁴⁰

The reason for the Treasury to include the concept of a bona fide cost sharing arrangement in the regulations was explained by the then acting Assistant Secretary of the Treasury for Tax Policy, Stanley S. Surrey, in an article published in the Journal of Taxation:

*“We recognize that the valuation of intangibles and the determination of an appropriate charge for their use present extremely difficult problems. For this reason, the proposed Regulations developed a ‘safe haven’ cost sharing arrangement in an attempt to eliminate many of the valuations which would otherwise be required.”*⁴¹

This builds on the fact that all group companies participating in a CCA become the owner of the cost shared intangibles from the very first moment that they come to exist and that they subsequently have access to those intangibles free of further charge. That way there does not have to be a taxable transfer or licensing of the intangibles to the other group companies and that signifi-

³⁸ Treasury and IRS, Proposed Transfer Pricing Regulations, 1966, 31 Fed Reg 10394 (1966).

³⁹ Treasury and IRS, Final Transfer Pricing Regulations, 1968, 33 Fed Reg 5854 (1968).

⁴⁰ Idem, Paragraph 1.482-2(d)(4).

⁴¹ Surrey, Journal of Taxation 1968, page 75 - 79.

cantly reduces the number of valuation issues. This *raison d'être* of the bona fide cost sharing arrangement was also confirmed in a separate publication by the Treasury issued contemporaneously to the 1968 Final Regulations. This outlined how those regulations first provided a general rule for determining arm's length results and subsequently specified five types of transactions. Under certain conditions the Regulations allowed a safe haven or *prima facie* rule. Cost sharing arrangements were considered one such safe haven:

*"The regulations provide a means whereby the necessity of determining the arm's length charge may be avoided if the parties using the property enter into a bona fide cost sharing arrangement in connection with the development of the intangible property."*⁴²

In other words the US Treasury intended CSAs to offer taxpayers an opportunity to avoid complex valuation issues in respect of intangible property. This intention was continued by Congress, when the United States in 1986 included a provision in Section 482 of the Revenue Code requiring the income from any transaction involving intangible property to be commensurate with the income attributable to such property. That will be further discussed in Paragraph 4.2.

2.2.2.2. *The 1979 OECD Transfer Pricing Report*

When the OECD published its first Transfer Pricing Report in 1979⁴³, the United States were still the only country contributing to the preparation of the Report to already have issued specific rules on the subject under its national law. At that point the OECD made the following noteworthy observation:

*"The United States tax authorities were led to adopt these rules mainly because various forms of cost sharing arrangements existed in practice and because a need was felt to accommodate their existence in the regulations. Experience with intra-group cost sharing arrangements is said to be positive and they do not appear to have opened up avenues for tax avoidance. No greater danger of tax avoidance is seen through cost sharing arrangements than through any other type of intra-group transaction."*⁴⁴

⁴² Treasury Department Press Release F-1217, 16 April 1968.

⁴³ OECD, "Transfer Pricing and Multinational Enterprises", 1979.

⁴⁴ Idem, Paragraph 109.

Apparently in the United States cost sharing arrangements were not regarded to facilitate tax avoidance any more than other legal arrangements. By not challenging this, the OECD accepted that presumption.

Although the leading role of the US undoubtedly further influenced the work of the OECD, the 1979 Report adopted its own terminology. It introduced the more general concept of cost contribution arrangements (“CCAs”), while the US Cost Sharing Regulations exclusively used the more narrowly defined cost sharing arrangements (“CSAs”). As the 1979 Report explains, the term CCA covers both CSAs and cost funding arrangements (“CFAs”). Under a CSA participants would agree to “*share the actual costs and risks of R&D undertaken for the benefit or expected benefit of each of them*”. Today the concept of a CSA is still used in the US Cost Sharing Regulations. Under a CFA on the other hand participants would be charged a generalized fee for certain centralized activities performed for their benefit. A CFA is similar to a CSA when it comes to the joint effective ownership of intangibles and the independent exploitation of results by participants. It is different however in how the amount of total charges is determined and allocated. While a CSA allocates actual costs, a CFA provides for a funding on a budgeted basis without a one-on-one relation to the actual costs incurred. It would allocate this among participants on the basis of some broad aspect of their business (e.g. gross turnover), which would not necessarily be proportionate to their expected benefits. CFAs could generally be regarded as a mandate to a designated group company to perform the centralized activities to the best of its ability in return for a fixed fee. In today’s fiscal practice the use of CFAs has diminished to the extent that in my experience it has become unusual to come across such arrangement. The more recent OECD’s guidance no longer includes any specific reference to these arrangements. In this study CFAs are not further addressed.

Besides the difference in terminology, there were two other noteworthy differences between the 1979 OECD Report and the US Cost Sharing Regulations. The first difference concerned the scoping of the arrangements at hand. Although the OECD included the wording on CCAs in the chapter on the transfer of technology and the use of patents and know-how, it mentioned explicitly that these arrangements could also cover the costs of various services, including non-technical activities like management and administrative services.⁴⁵ The US Cost Sharing Regulations on the other hand had focused on the use of CSAs for activ-

45 Idem, Paragraph 102.

ities aimed at the development of intangible assets.⁴⁶ The second difference was even more fundamental and is still an issue of debate today. It concerns the matter of whether or not contributions of participants should be valued at cost or at market price. The latter would assume that a certain profit element needs to be included as a consideration for the functions performed by the contributor. The US traditionally accepted a valuation at cost, i.e. without any profit element included. In the 1979 Report however, the OECD expressed another opinion. It considered the following:

“To the extent that the enterprise carrying out the research is relieved of risk because it could rely on its costs being met by the participating members of the group, then any profit mark-up should not take account of such risk and ought to be limited to a reward for its activities in organizing and managing the relevant research project or projects. But it seems difficult to accept that there would often be genuine cases of cost sharing arrangements in the arm’s length situation. Accordingly, it would usually be right to look for a profit mark-up in cases of cost contribution arrangements.”⁴⁷

As the valuation of contributions determines what balancing payments are required between participants, it is a key aspect of any CCA. For that reason it is also at the core of the OECD’s more recent guidance, as prepared under the BEPS project.⁴⁸ The valuation of contributions at cost or at market price will be extensively discussed in Paragraph 5.5.3, where I will also explain why for a CCA to comply with the arm’s length standard, there should indeed be a profit element included. The calculation of balancing payments will subsequently be discussed in Paragraph 5.6.

2.2.2.3. The 1984 OECD Supplements

In 1984 the OECD published three Supplements to its 1979 Report, the third of which dealt with the allocation of central management and services costs.⁴⁹ It recognized again that CCAs offer a relatively simple method for recharging managerial and coordination costs. Their use for such purpose was clearly sanctioned, even though it may not be common on the open market:

⁴⁶ Today’s US Cost Sharing Regulations still define a CSA as “an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their reasonably anticipated benefit shares” (Treasury and IRS, 2011 Final Cost Sharing Regulations, 76 Fed Reg 80082 (2011), Paragraph 1.482-7(b)).

⁴⁷ OECD, “Transfer Pricing and Multinational Enterprises”, 1979, Paragraph 119.

⁴⁸ OECD/JG20, “Aligning Transfer Pricing Outcomes with Value Creation”, 5 October 2015.

⁴⁹ OECD, “Transfer Pricing and Multinational Enterprises – Three Taxation Issues”, 1984.

*"...it may ... be questioned whether such arrangements correspond to the arrangements which would be made between unrelated parties. Nevertheless, it would be wrong to completely disregard the special situation of MNEs and the fact that these methods are not applied, or are very seldom applied between unrelated parties, ought not to lead one to conclude that they necessarily produce charges which must be regarded as not at arm's length. In making judgment as to whether any particular instance of the use of such methods is acceptable, there should also be taken into consideration such relevant factors as the amount of the charge or the terms of any formal contract, and the reason why the method has been used."*⁵⁰

Next to this, the 1984 Supplements underlined that under circumstances an indirect cost allocation would be acceptable and that the appropriate method to do so is by using a key that ensured the sharing of actually incurred costs in proportion to the benefits or expected benefits of each group company.⁵¹ Furthermore, the OECD repeated yet again that it would normally be appropriate to add a profit mark-up to the resulting intercompany charges.⁵²

2.2.2.4. The 1995 US Cost Sharing Regulations

In 1995 the United States issued a first set of final regulations dealing specifically with cost sharing arrangements.⁵³ These regulations define a CSA as:

*"...an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement."*⁵⁴

The preamble to these regulations again refers to CSAs as a safe haven. It can be concluded that the purpose of the arrangements was still considered to be a way for taxpayers to avoid complicated valuation issues. At the same time the Treasury and IRS explicated that the taxpayer claiming the benefits of such safe haven had to meet certain formal requirements. Besides outlining these requirements the regulations also provided detailed guidance on how to apply the arm's length principle to a CSA. It considered it relevant that participants

⁵⁰ Idem, Paragraph 63.

⁵¹ Idem, Paragraph 65.

⁵² Idem, Paragraph 76.

⁵³ Treasury and IRS, 1995 Final Cost Sharing Regulations, 60 Fed Reg 65557 (1995).

⁵⁴ Idem, Paragraph 1.482-7(a)(1).

would share in the costs of all development stages, regardless of whether the research was successful or unsuccessful. Contrary to the 1979 OECD Report and the 1984 Supplements the 1995 Cost Sharing Regulations, which are further discussed in Paragraph 4.2.1, did not require a profit element to be added to these costs.

2.2.2.5. *The 1995 OECD Transfer Pricing Guidelines*

In April 1993 the OECD's Committee on Fiscal Affairs established a task force to revise the 1979 Report. This was intended to amalgamate the Report and the 1984 Supplements as well as the additional work of the Committee carried out since then, to update the guidance and reflect technological developments and the increasing globalization, to take away remaining ambiguities on the use of profit methods and to respond to revisions of legislation and practices in a number of countries.⁵⁵ The efforts resulted in Transfer Pricing Guidelines approved by the Committee in June 1995 and published just one month later.⁵⁶ The Guidelines originally consisted of five chapters, but they were later expanded, among others with a separate Chapter VIII on CCAs. This was approved in June 1997 and then published in September of the same year. The new chapter on CCAs provided general guidance on the tax treatment of the arrangements and was an addition to the previous chapters of the Guidelines, which therefore unrestrictedly remained applicable. It provided yet another definition of a CCA:

*"A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights."*⁵⁷

Although the 1997 Chapter VIII was significantly more extensive than anything the OECD had ever before published on the topic of CCAs, it was never intended to resolve all CCA related issues. From the way in which that was made explicit one might deduct that the OECD backed away from the position it had taken in the 1979 Report and 1984 Supplements on the pricing of contributions at market value:

⁵⁵ Hay, Horner and Owens, Intertax 1994/10.

⁵⁶ OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", 1995.

⁵⁷ Idem, Paragraph 8.3 (old).

"This chapter does not resolve all significant issues regarding the administration and tax consequences of CCAs. For example, further guidance may be needed on measuring the value of contributions to CCAs in particular regarding when cost or market prices are appropriate..."⁵⁸

At the same time it was anticipated that additional work would also have to be done to clarify the tax characterization of CCA related payments, which is decisive for their treatment under general tax rules and regulations including those laid down in tax treaties. Such treatment for example determines whether or not these payments are subject to source state taxation.⁵⁹

Furthermore, for the first time the OECD seemed to express some doubt about whether or not CCAs offered tax planning opportunities. The Transfer Pricing Guidelines therefore required taxpayers to substantiate the arm's length outcome of their CCAs:

"The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA."⁶⁰

In years following the publication of this new guidance these concerns increased. In 2010 the US Joint Committee on Taxation submitted a report to the House Committee on Ways and Means, which included 6 case studies of aggressive tax structures used by US-based MNEs.⁶¹ These cases were anonymized, with taxpayers being referred to as Alpha, Bravo, Charlie, Delta, Echo and Foxtrot Company. In three of them a CCA played an important role. These case studies will be further discussed in Paragraph 2.3.2.

2.2.2.6. The 2011 US Cost Sharing Regulations

At the beginning of this century the United States started to become more concerned about multinationals using CSAs to locate high value intangibles in low tax jurisdiction. This was reason for a full review of the 1995 Cost Sharing

⁵⁸ Idem, Paragraph 8.1 (old).

⁵⁹ This aspect will be further discussed in Chapter 8.

⁶⁰ OECD Transfer Pricing Guidelines, Paragraph 8.15 (old).

⁶¹ Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing", 20 July 2010.

Regulations, which eventually resulted in new regulations being issued in 2011.⁶² These included the following updated definition of a CSA:

"A cost sharing arrangement is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their share of reasonably anticipated benefits."⁶³

Among others the 2011 Final Cost Sharing Regulations opened the door to using a more market based approach for valuing certain specific functions performed under a CSA. This was explained already in the preamble to the 2008 Temporary Cost Sharing Regulations, which worded it as follows:

"... to the extent a controlled participant ... contributes the services of its research team for purposes of developing cost sharing intangibles pursuant to the CSA, the other controlled participant would owe compensation for the services of such team ..., just as would be the case in a contract research arrangement."

The 2011 Final Cost Sharing Regulations continued that approach and included the example of a pharmaceutical company committing its experienced R&D team to the cost shared development of a vaccine.⁶⁴ In this example the Treasury and IRS consider that in addition to the ongoing costs of the research team the company in question should receive a consideration for having this workforce in place. However, the Cost Sharing Regulations prescribe that it should be paid as part of a separate transaction, referred to as a platform contribution transaction, which compensates for all resources made available that pre-exist externally from the CSA. This approach differs fundamentally from that to include a profit element in the valuation of current contributions. That had significant consequences when taxpayers challenged the US approach in court, as is further explained in Chapter 4.

2.2.2.7. The 2015 OECD/G20 BEPS Project Final Report

As already mentioned, in 2012 concerns about increasing tax avoidance by MNEs inspired the G20 to initiate an OECD driven project against base erosion and profit shifting. The Action Plan developed in this context aimed to ensure

62 Treasury and IRS, 2011 Final Cost Sharing Regulations, 76 Fed Reg 80082 (2011).

63 Idem, Paragraph 1.482-7(b).

64 Idem, §1.482-7(c)(5), Example 2.

that transfer pricing outcomes are in line with value creation.⁶⁵ However, it was made very clear that this would be pursued without abandoning the current transfer pricing system based on the arm's length standard. Alternatives, such as formula based systems, were rejected and it was instead decided to build on the existing foundations, albeit, where needed, with the help of so called special measures, either within or beyond the framework of the arm's length standard. Specific actions in this context addressed the position of intangibles, the transfer of risk and allocation of excessive capital to group companies and the issue of transactions that are uncommon between third parties.⁶⁶ Ultimately the BEPS project resulted in a number of Final Reports published in October 2015, one of which addressed the above identified transfer pricing issues.⁶⁷ A dedicated section of this Report provided for the announced changes to Chapter VIII of the Transfer Pricing Guidelines. It most notably featured two fundamental policy decisions.

First of all the OECD expressed its opinion that third parties behaving in a commercially rational manner in comparable circumstances would not enter into a CCA, unless all of the participants would exercise control over the risks associated with the cost shared activities.⁶⁸ That implies that each participant should employ personnel that is capable of making decisions, and actually makes decisions, about taking on or laying off the risks as well as responding to those risks. When this precondition is not met, tax administrations would be in their right to disregard the arrangement, assume an alternative transaction, for example a royalty bearing license, and adjust the taxable profit of the companies involved accordingly. This "*control-over-risk requirement*" is discussed in more detail in Paragraph 5.3.2.

The second principal choice in the final BEPS report was to reinstall the OECD's positioning in the 1979 Report and the 1984 Supplements that contributions have to be valued at market price instead of at cost, i.e. that they have to include a profit mark-up:

"Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises in comparable circumstances would have assigned to that contribution. That is, contributions must generally be assessed based on their value at the time they are contributed, bearing in mind the mutual sharing of risks, as well as

65 OECD/G20, "Action plan on Base Erosion and Profit Shifting", 19 July 2013.

66 This concerns actions 8, 9 and 10 of the Action Plan respectively.

67 OECD/G20, "Aligning Transfer Pricing Outcomes with Value Creation", 5 October 2015.

68 Idem.

the nature and extent of the associated expected benefits to participants in the CCA, in order to be consistent with the arm's length principle."⁶⁹

The justification and consequences of this second policy decision are further outlined in Paragraph 5.5.3.

2.2.3. Legal Status

2.2.3.1. Joint Ventures

Now that CCAs have been identified as an established concept in the context of transfer pricing and international tax law, it is a logical next step to make some general remarks about their legal status. First of all it may be considered whether CCAs can qualify as a joint venture. If a joint venture is defined as any form of economic cooperation, then almost every commercially driven arrangement qualifies as such and there is no reason why CCAs would be an exception to that rule. However, a categorization using this broad definition would not be very useful and lack legal relevance. Alternatively a joint venture has been more specifically defined as an agreement between two or more related or unrelated parties outlining a stable and interactive legal structure aimed at achieving a common business objective.⁷⁰ Under this narrower definition it is the common objective that distinguishes joint ventures from other commercial transactions. This implies a benefit external to the agreement, whereas with other commercial transactions the benefit for one party would consist more directly out of the consideration in cash or kind received from the other party. The narrowly defined joint ventures can subsequently be split up into cooperative joint ventures and contractual joint ventures. Joint ventures of the first category establish a new legal entity, while joint ventures of the second category do not.

A CCA will feature all elements of the above narrower joint venture definition. In fact the benefit external from the agreement, i.e. the fact that participants become the collective owner of results and can exploit them individually, is a crucial factor distinguishing it from most other intercompany transactions. By itself however that will not lead to the establishment of a new legal entity. Therefore, a CCA generally qualifies as a contractual joint venture. More precisely a "*development-only joint venture*" instead of a joint venture aimed at earning income.⁷¹ That means that the arrangement is limited to sharing the costs and

69 OECD Transfer Pricing Guidelines, Paragraph 8.25.

70 A.J. Belohlavek, "Law Governing Joint Venture Status and Joint Venture Agreements", in Campbell, Netzer et al 2009.

71 Also see Brabenec 2010.

risks associated with the activities in scope and does not extend to the benefits of participants from their subsequent individual exploitation of results.

Qualification as a contractual joint venture offers an MNE the freedom of choice as to what law governs the agreement.⁷² It also has certain public law implications. However, this relates foremost to competition law, the rules of which are generally already applicable to the participants in a CCA because of their affiliation as members of the same multinational group. Finally, and perhaps more relevantly for the purpose of this study, it should be acknowledged that as a contractual joint venture a CCA does not by itself constitute a taxable entity.

2.2.3.2. *Partnerships*

The specific conditions for an agreement to qualify as a partnership differ per jurisdiction. However, in most countries a CCA will not be regarded as such.⁷³ The reason for this is that the characteristics of a CCA differ from those ordinarily required by private law for the recognition of a partnership. The most notable differences are as follows:

- (i) As an internal agreement between group members there is no external trade in the name of the CCA, whereas partnerships will often act on the market in their own name.
- (ii) A CCA itself does not hold any property. Instead property related to or resulting from cost shared activities is held by individual participants. Partnerships on the other hand may under certain conditions hold property in their own name.
- (iii) Under a CCA participants share costs and risks and subsequently exploit the resulting assets, services or rights for their own use. They are all individually entitled to proceeds of that exploitation. In contrast, under a partnership the services, assets and rights are exploited by the partnership itself.

Not qualifying as a partnership has both legal and tax implications. It limits liability of participants towards creditors. While often all partners are collectively liable for debts of a partnership, participants in a CCA will only be liable for debt following from the third party transactions that they entered into in their own name (although that does not limit an internal right of recourse against the

⁷² See Article 3 of Regulation (EC) 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I).

⁷³ Also see J. Malherbe, “*Cost Contribution and Cost Sharing Arrangements*”, in Jochum et al 2016.

other participants for their pro rata share, if there is a relation to cost shared activities). Furthermore, not incorporating a legal entity and not qualifying as a partnership confirms yet again that the CCA itself is not a taxable entity. Instead the participants are taxable individually. Closely related to this matter, albeit a fundamentally different issue, is whether or not a CCA can lead to a tax liability of a participant in another country by constituting a permanent establishment. This question will be answered in Paragraph 8.2.

2.3. Application in Fiscal Practice

2.3.1. Legitimate Use

The foregoing addressed the original purpose for the introduction of the CCA concept, the developed thinking by tax authorities about their application in practice and the legal status of the arrangements. Before looking at tax and transfer pricing technical aspects in more detail, it is good to determine why MNEs would choose a CCA to structure their intragroup development activities or services. The legitimate reasons for doing so can be divided up into five categories:

(i) **A Free Flow of Expertise and Knowledge**

A strong knowledge base is considered to offer a key competitive advantage to MNEs. In fact, it has been argued by scholars in the field of strategic management research that the primary reason why multinationals exist is their ability to transfer and exploit knowledge more efficiently and more effectively in the intra-corporate context than through external market mechanisms.⁷⁴ If group members have continuous unlimited access to the group's collective know-how, this will increase the chances of achieving economies of scale. A CCA can constitute a legal framework for the flow of knowledge within the group. By providing for collective ownership of cost shared results it allows participants a legal title to make use of the services performed by experts located elsewhere within the group and access to jointly developed intangibles.

(ii) **Risk Sharing across the Group**

CCAs allow for a division of costs and risks associated with the cost shared activities among the participants. If a project performed under a CCA does not pay off or results in a lower return than expected, the costs and dis-

⁷⁴ Gupta and Govindarajan, *Strategic Management Journal* 2000/4.

pointment about proceeds are shared by all participants. This encourages activities that might be too costly or too risky for one enterprise to initiate by itself. At the same time it is a mechanism to allocate costs appropriately among benefiting group members. That facilitates the tax deductibility of the costs, which brings down the group's current tax charge in a way that is coherent with the arm's length standard. Provided that the cost allocations are reported "*above the line*" for management reporting purposes, they can at the same time enable management to more accurately measure the business performance of the individual enterprises and base management decisions as well as its employees remuneration plan on the resulting insights.

(iii) Avoidance of an Intercompany Transfer of Intangibles

As already mentioned in Paragraph 2.2.2.1 the original reason for the introduction of CSAs in the 1968 US Transfer Pricing Regulations was to offer MNEs an option to allow their group companies access to jointly developed intangibles, without having to separately transfer those intangibles to those group companies or to grant them a right of use. This offers MNEs two critical benefits. First of all, it prevents recognition of taxable income on the separate transfer of the intangibles. Such front loading of profit could otherwise be regarded quite unfair by the MNE, as it will from a group perspective often not yet have realized any (external) profit at the time of the intercompany transaction. Secondly, avoiding an intercompany transfer of intangibles also avoids an often complex valuation exercise. This prevents a cumbersome and to some extent arbitrary exercise to determine the fair market value of the intangibles on the basis of difficult to verify financial projections. By consequence, it also reduces uncertainty and potential disputes.

(iv) Administrative Simplicity

Activities are often physically centralized in the group's parent company, regional and divisional headquarter companies or so called shared service centers. Alternatively an MNE may functionally centralize activities in staff departments, while the employees belonging to that department are divided over multiple group companies and can be physically located in different places. When services are only functionally and not physically centralized, this can cause transfer pricing complications. There are not only multiple service recipients, there are also multiple service providers. Formalizing these relationships in unilateral agreements would require a complex web

of intra-group contracts. It would have to be defended on a contract-by-contract basis that service providers receive a fiscally acceptable remuneration. A CCA on the other hand offers the advantage of contractual simplicity. It guarantees a consistent transfer pricing approach throughout the group, allowing the MNE to defend the single framework agreement instead of multiple SLAs. On the other hand not all related companies are necessarily in a comparable position. Especially in a larger multinational group, circumstances of group members can be quite different. Within different geographical regions or divisions the market circumstances, the organizational set-up, legal structure and assumed transfer pricing policies may differ. A one-size-fits-all CCA is then not possible. Furthermore, just like administering multiple unilateral service agreements, operating a CCA can also be a cumbersome exercise. It will have to be tested on an ad hoc basis what type of arrangement best fits the MNE's organization.

(v) Upfront Clarity about Cost Reallocations

Last but not least a CCA offers an opportunity to establish upfront clarity and consistency in respect of cost reallocations within the group. This avoids managerial and budget discussions in respect of individual service and license agreements. It also has the benefit of certainty on the tax treatment once a CCA has been approved by local tax administrations either in an upfront tax ruling or after a tax audit. Especially if a multilateral advance pricing agreement could be obtained to which the most relevant tax administrations involved sign up, that significantly reduces the risk of double taxation, interest charges and penalties. The procedures for obtaining advance certainty are further discussed in Paragraph 9.2.

2.3.2. Tax Avoidance

2.3.2.1. Introduction

The advantages outlined in the previous paragraph provide legitimate business reasons for MNEs to enter into a CCA. Unfortunately, as already acknowledged, CCAs are also used in structures aimed at eroding the tax base in high tax jurisdictions by shifting profit into low tax jurisdictions. Although there can be discussions about the transfer pricing outcomes of these structures or their qualification under international tax law, by themselves they do not qualify a fraud or abuse of law. As such, the only way to limit their effectiveness without disproportionately restricting the bona fide use of CCAs is through enhanced guidance on their appropriate tax and transfer pricing treatment or targeted

anti-abuse rules. The recent efforts made by the OECD under the BEPS project can be considered an attempt to provide such guidance. To further place that in perspective, this Paragraph 2.3.2 illustrates how CCAs have been used in tax avoidance structures. In that context it examines the case studies included in the Report that the US Joint Committee on Taxation submitted to the House Committee on Ways and Means in 2010⁷⁵ to facilitate the identification and discussion of business structures that may affect a taxpayer's US and worldwide tax liability. These case studies were anonymized, with taxpayers being referred to as the Alpha, Bravo, Charlie, Delta, Echo and Foxtrot company. In three out of the six case studies a CCA played a crucial role. Furthermore, Paragraph 2.3.2.5 considers an example from the OECD's Base Analysis Report on Base Erosion and Profit Shifting that also prominently featured a CCA.

2.3.2.2. *US Case Study 1: Bravo Company*

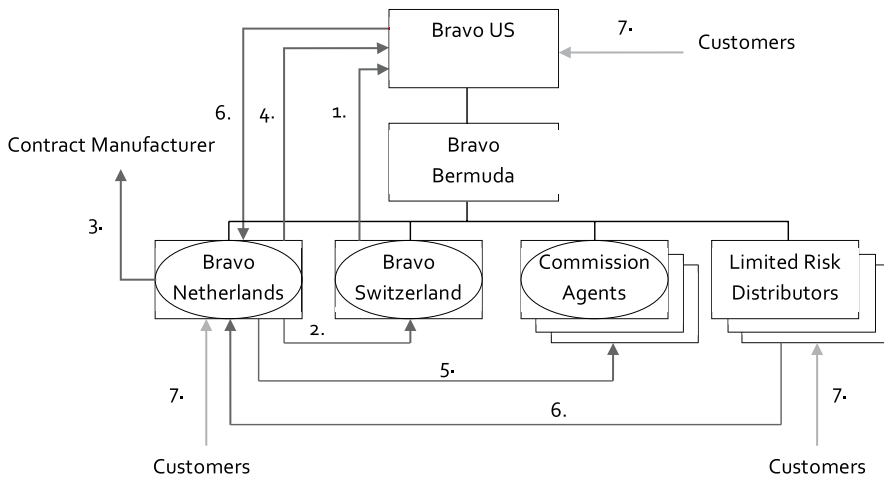
2.3.2.2.1. *Group Structure and Business Model*

Bravo Company is a major US-based publicly listed MNE involved in the sale of industrial technology products and services. It has sizeable sales around the world and a multibillion dollar annual global profit. Bravo has a substantial R&D spend and performs its R&D activities almost exclusively in the US. Bravo US holds its foreign subsidiaries via a Bermuda intermediate holding company. Key roles in the tax structure are for a Swiss and Dutch group company. Other subsidiaries are located worldwide. In the 1990's Bravo decided that Bravo US would continue to be responsible for manufacturing and selling existing products, but that going forward the intangible assets related to newly developed product lines would be centralized in Bravo Switzerland while the primary responsibility for manufacturing and selling new products would come to rest with Bravo Netherlands. In this context Bravo US entered into a cost sharing arrangement with Bravo Switzerland, so that the effective ownership of newly developed intangibles was from then on split between Bravo US and Bravo Switzerland. To also allow Bravo Switzerland access to all pre-existing intangibles a buy-in payment was agreed in the form of a royalty declining on the basis of an assumed four years useful lifetime of the intangibles. Once the structure was up and running Bravo Switzerland fully recovered the total buy-in royalty within three years. Over the years Bravo also acquired several companies with US owned intangible property. To the extent Bravo Switzerland was considered

75 Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing", 20 July 2010.

to make use of such intangibles, the CSA was amended and an appropriate additional buy-in payment was agreed. The CSA further provided for total R&D costs to be split between Bravo US and Bravo Switzerland on the basis of the sales of old and new products. As the sales of new products initially accounted for approximately 25% of total sales, Bravo Switzerland started off to pay 25% of the total R&D spend. When over time the sales of new products as a percentage of total sales increased, the cost sharing payments were adjusted accordingly and Bravo Switzerland paid a larger part of the total R&D costs.

Bravo Switzerland, which employed no personnel of its own, licensed out the right to use intangibles developed under the cost sharing to Bravo Netherlands. The latter company was responsible for manufacturing and distributing new products and bore all significant risks in that relation. Among others this included the manufacturing risk (including risk of obsolete stock), the product and quality risk and the bad debt risk. However, Bravo Netherlands also employed only a limited workforce. It outsourced all the actual manufacturing to unrelated contract manufacturers and most of the actual distribution to related limited risk distributors. Bravo US acted as the limited risk distributor for all sales of new products in the US. In a number of other jurisdictions Bravo Netherlands sold directly to customers. In those instances it received sales support from related party commission agents. Contract manufacturers, limited risk distributors and commission agents all received a fixed remuneration determined on a cost-plus or resale-minus basis. Furthermore, various types of support services were performed by Bravo US. This included procurement services, general marketing and sales support services, factoring services, administrative services as well as tax, legal and treasury services. All these services were compensated on a cost-plus basis. The business model in respect of new products can be summarized as follows:



1. Buy-in royalties for the use of pre-existing intangibles and cost sharing payments for ongoing R&D activities
2. Royalties for the use of intangibles
3. Cost-plus service fee for manufacturing
4. Cost-plus service fee for support services
5. Cost-plus service fee for sales support
6. Resale minus price for intercompany sales of finished products
7. Third party purchase price for finished products

Figure 2: "Bravo Case Study"

2.3.2.2.2. Tax Treatment

In respect of manufacturing and selling of new products Bravo US earned a profit mark-up on the limited risk distribution activities and support services that it performed, which was included in its US taxable base. Next to this the royalties received from Bravo Switzerland as cost sharing buy-in payments were also taxable in the US. The same applies for the cost sharing payments, but those were offset against tax deductible R&D expenses and thus effectively did not result in US taxable profit. Meanwhile, Bravo US was entitled to an R&D credit for all R&D costs, even those reimbursed by Bravo Switzerland.

US law includes an extensive set of rules under which certain types of income of controlled foreign corporations ("CFCs") is included in the taxable base of a US parent company. However, various exceptions to these rules can apply. In this case none of the foreign profit was included in the US taxable base under the US CFC legislation. The royalty income of Bravo Switzerland was disregarded, because the royalty payer (Bravo Netherlands) and the royalty recipient (Bravo Switzerland) both elected the status of disregarded entity for US tax purposes

under the so called check-the-box regime. Furthermore, the profit of Bravo Netherlands, including the profit of the disregarded commission agents, as well as the profit of the opaque limited risk distributors qualified for the manufacturing exception, because the US CFC rules attributed the manufacturing activities of the contract manufacturers to Bravo Netherlands.

Bravo Switzerland earned a spread from developing and licensing out new intangibles. Initially the Swiss profit was reduced substantially by the deductible buy-in royalties. However, this royalty decreased to nil over the assumed relatively short useful lifetime of the pre-existing intangibles, causing the part of profits that was taxable at a favorable rate in Switzerland to increase quite rapidly. Another substantial share of the profits from the sale of new products ended up with Bravo Netherlands. Generally, it would have been taxable at the normal Dutch statutory rate (25.5% in 2010). However, it is implied that Bravo Netherlands concluded a tax ruling with the Dutch tax authorities that significantly reduced the Dutch tax burden. Unfortunately the content of the ruling is not discussed in the Report. It should be noted here that the Dutch tax authorities do not agree rulings simply foreseeing in a lower tax rate. More likely the Dutch tax authorities allowed for a generous deduction of royalties paid to Bravo Switzerland. Now that no further details are available it is uncertain what the effective tax rate on the remaining Dutch taxable income was. Nevertheless, even at the normal Dutch rate of 25.5% it would have been significantly below the US combined federal and state tax rate of almost 40% at the time. Bermuda, for completeness sake, did not impose a material tax on any of the group's profit either. As a consequence, the structure allowed for Bravo Company to keep the majority of its profit outside the US. The Report indicates that one third of the total profit was taxable in the US at approximately 40%, while the rest was taxed abroad at a mixed rate of approximately 4%. Meanwhile more than 97% of Bravo's workforce was employed in the US and all its R&D activities were performed there.

2.3.2.2.3. Author's Analysis

Bravo Company's tax structure was aimed at allocating profits from new products to two jurisdictions with favorable tax regimes. These are the Netherlands and Switzerland. Bravo Netherlands was attributed a substantial share of the total profits, in part because it coordinated manufacturing and distribution. This will have involved some relevant functions being performed by the limited number of employees in the Dutch company. It appears that another relevant factor for attributing profits to Bravo Netherlands was the risks that it assumed. Bravo Switzerland on the other hand was entitled to significant profits, because

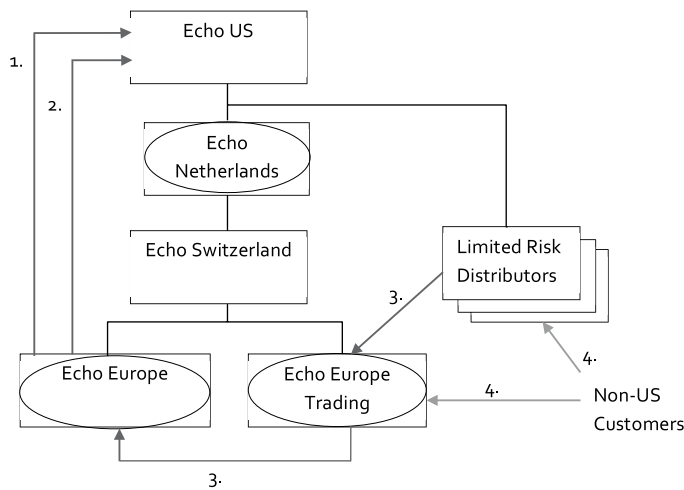
it had become the owner of the group's intangibles related to new product lines under the CSA from the moment those had come to exist. It had borne the costs and the risks in respect of the intangibles' development. The buy-in payments for pre-existing intangibles were a part of that. However, the buy-in royalty was recouped in as little as three years. Furthermore, its overall substance was minimal and it had not performed any development activities itself. In fact it had performed no material functions besides holding intangibles. Bravo Company tried to leverage the argument that its Swiss subsidiary had borne the financial risk of the development of new activities and was therefore entitled to the results of the cost shared marketing and R&D activities. In testing the validity of this position the US rules disregarded that Bravo Switzerland did not have actual substance. It did not employ personnel capable of making relevant business decisions and control the risks associated with the cost shared activities. As a consequence, the US rules effectively offered Bravo Company the opportunity to allocate its intangibles to Switzerland under favorable conditions and shift profits from manufacturing and selling new products to jurisdictions with a significantly lower effective tax rate than the United States. In my opinion the main CCA related issue that comes to the surface in this case study is the lack of substance requirements imposed on CCA participants. As a consequence, the applicable rules and regulations offered the opportunity for a low taxed foreign group company with minimal substance, in this case Bravo Switzerland, to assume effective ownership of the group's intangibles at a limited cost (not in the least because of the rapid decline of the buy-in royalty) without performing any of the underlying development activities. This resulted in a tax structure that was significantly disconnected from the group's actual business operations, while it resulted in the majority of profits being taxed at rates far below the rate applied in the United States.

2.3.2.3. US Case Study 2: Echo Company

2.3.2.3.1. Group Structure and Business Model

Echo Company is a US based publicly listed MNE in the business of manufacturing and selling technology-based consumer products. It has significant R&D activities that are almost exclusively performed in the US. For many of its products Echo has registered a patent. Echo's legal structure includes a Swiss subsidiary held via a Dutch entity that was disregarded for US tax purposes. The Swiss sub in its turn holds two other Swiss companies, both of which were also disregarded from a US perspective.

During the study period most of the group's products were manufactured in Puerto Rico. However, for a key product line Echo structured the manufacturing and non-US sales differently. These products were manufactured by one of the disregarded Swiss entities, Echo Europe, that had entered into a cost sharing agreement with Echo US. As a buy-in payment for pre-existing intangibles Echo Europe paid Echo US a declining royalty. The time-period of the royalty was product dependent, but never exceeded 10 years. Ongoing R&D costs were shared using a sales key. Furthermore, Echo Europe also purchased component parts from Echo US. Echo Europe sold finished products to the other disregarded Swiss entity, Echo Europe Trading. The transfer price was set so that the latter company earned a fixed 2% return on sales. Echo Europe Trading then sold the products to non-US customers either directly or via related limited risk distributors. This led to the following business model in respect of non-US sales:



1. Buy-in royalties for the use of pre-existing intangibles and cost sharing payments for ongoing R&D activities
2. Comparable uncontrolled price for component parts
3. Resale-minus price for intercompany sales of finished products
4. Third party purchase price for finished products

Figure 3: "Echo Case Study"

2.3.2.3.2. Tax Treatment

The buy-in royalty and cost sharing payments received by Echo US were included in the US taxable income. However, they were for a substantial part offset by tax deductible R&D costs, in respect of which Echo might also have been eligible

for a US tax credit. Furthermore, there was the purchase price received by Echo US for the components it supplied to Echo Europe, but this appears to have included only a minimal part of the profit margin earned. Most of the profit from the sale of the products outside the US ended up in Switzerland, where it was taxed at a relatively favorable rate. Echo Europe Trading earned a modest return on sales, while residual profit flowed to Echo Europe. From a US perspective these companies were disregarded, just like Echo Switzerland's Dutch parent company, and the income was attributed to Echo Switzerland. However, for purposes of US CFC legislation practically none of Echo Switzerland's income was included in the US taxable base.

2.3.2.3.3. Author's Analysis

This case study again offers an example of a multinational that had centralized its R&D activities in the US, but structured its business model so that most of the profits were taxed elsewhere. Here Echo Company was able to keep the profits from the sale of a key product in Switzerland. Crucially there was no royalty payment to Echo US required for the use of manufacturing intangibles, because Echo Europe was a co-developer and co-owner of the relevant intangibles under the CSA. The Swiss organization shared in costs of R&D activities, manufactured the products and was responsible for sales. It also bore all significant risks in respect of these activities and potentially employed personnel that was capable of taking relevant business decisions in this respect and thereby control these risks. Echo clearly had significantly more substance than the Swiss IP subsidiary of Bravo Company. However, its active involvement in the actual development of intangibles was still limited. In fact all development activities were in the US, while under the CSA Echo US received compensation on a cost basis. As a consequence, also in this structure the CSA enabled a certain shift of profits to a jurisdiction that applied a more favorable tax rate. This effect was made possible by an under-appreciation of the R&D functions performed in the US. In my opinion the key CCA related issue to be identified in this case study therefore is the unsatisfying outcome from valuing Echo US' contributions under the CSA at cost instead of at market price.

2.3.2.4. US Case Study 3: Foxtrot Company

2.3.2.4.1. Group Structure and Business Model

The third case study from the US Report involving a cost sharing agreement features a global multinational that manufactures, markets, and sells a broad variety of consumer goods. This company is referred to as Foxtrot. The group's

legal structure included a Bermuda intermediate holding company as well as a Dutch and a Hong Kong subsidiary. The latter two entities were disregarded for US tax purposes. During the study period approximately 50% of its revenues came from sales in the United States. The company's R&D spend was near to 3% of sales, with all R&D activities being performed in the US.

In the mid-1990's Foxtrot decided to make its foreign subsidiaries responsible for non-US activities. For this purpose Foxtrot US and Foxtrot Bermuda entered into a CSA. This arrangement made Foxtrot Bermuda the effective owner of intangibles related to products sold outside of the US and entitled it to the profits from their trade. In return Foxtrot Bermuda paid a buy-in payment for pre-existing intangibles and a relative share of total R&D costs. The buy-in was structured as a declining royalty over a 10-year period. Shared R&D costs were split on the basis of each participant's sales compared to total sales. With almost 90% of R&D costs covered by the cost sharing agreement and around 50% of sales outside the US, Foxtrot Bermuda paid for approximately 45% of the total R&D spend. Within the group Foxtrot Netherlands took on key responsibilities coordinating the manufacturing, marketing and sale of all Foxtrot products. It engaged a number of toll manufacturers, out of which Foxtrot Hong Kong was the greatest by volume. Raw materials were bought in the name of Foxtrot Netherlands and Foxtrot Netherlands held ownership of stock at all times. The toll manufacturers received a service fee set equal to their own costs increased by a profit mark-up of 5%. Finished products were sold by Foxtrot Netherlands to associated distributors, who on-sold to third party customers in their own territories. Transfer prices were generally set so that the local distributors only earned a limited return on sales. The only exception to this rule was Foxtrot US, that was allowed to buy products at a lower price reflecting its ownership of intangibles related to US sales. For the use of the intangibles related to non-US sales Foxtrot Netherlands paid a royalty to Foxtrot Bermuda.

The new business model can be summarized as follows:

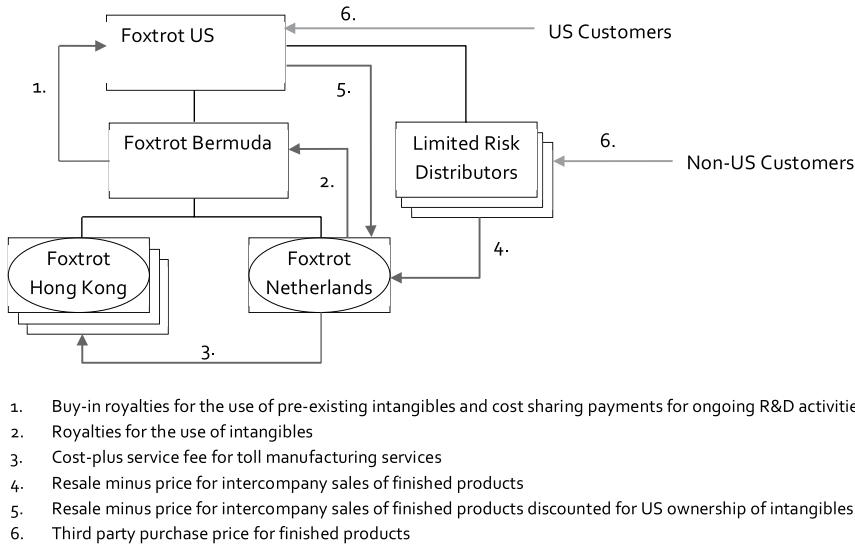


Figure 4: "Foxtrot Case Study"

2.3.2.4.2. Tax Treatment

The revenue from the sale of products to US customers, the buy-in royalties and cost sharing payments were all included in the US taxable base. The US taxable profit was decreased by the purchase price for finished products paid to Foxtrot Netherlands, the R&D costs incurred in the US and the own operating costs of Foxtrot US. Although on balance the R&D activities paid for by Foxtrot Bermuda did not generate any future US taxable income, Foxtrot US was eligible for a tax credit in their respect. Toll manufacturers like Foxtrot Hong Kong and local associated distributors earned a limited fixed profit. Residual profit ended up with Foxtrot Netherlands. Its Dutch taxable profit was however eroded by the royalty payment to Foxtrot Bermuda, where there was no pick-up due to a lack of any corporate income taxation in Bermuda. The size of the royalty was agreed in an advance pricing agreement with the Dutch tax authorities. Although the Netherlands tax authorities consistently apply OECD transfer pricing guidance, the report of the Committee suggests that the royalty for which they allowed a deduction in this case was relatively high.

2.3.2.4.3. Author's Analysis

The Foxtrot case study shows a strong similarity to that of Bravo explained before. In both cases the tax structure relied on a CSA to place the effective ownership of intangibles with cash box companies located in a low tax jurisdic-

tion outside the US. The involvement of these cash box entities in R&D activities was limited to paying their share and bearing the associated financial risk. Active involvement was non-existent and in fact their overall substance was extremely small. They did not employ any personnel nor did they perform valid business functions. To the contrary, their inclusion in the structure appears to have been predominantly, if not exclusively, tax driven. However, Foxtrot Bermuda paid a more generous buy-in royalty (10 years) than Bravo Switzerland (4 years). Furthermore, Foxtrot's CSA only transferred intangibles related to sales outside the US to its low taxed subsidiary and the purchase price for finished products paid by Foxtrot US to Foxtrot Netherlands was discounted accordingly. It can therefore be argued that in respect of certain elements Foxtrot's approach is somewhat less aggressive than that of Bravo. Nevertheless, according to the Report by the Committee on Ways and Means, the structure allowed for Foxtrot to assert reinvestments abroad and thereby defer US taxation on earnings of more than US\$ 50 billion! Like in the Bravo case, this was facilitated by the US tax and transfer pricing rules that allowed a low substance tax haven entity, in this case Foxtrot Bermuda, to participate in the CSA. As such, this case study is again a good illustration of why substance requirements should be imposed on CCA and CSA participants. This will be further discussed in Paragraph 5.3.2.

2.3.2.5. *OECD Example*

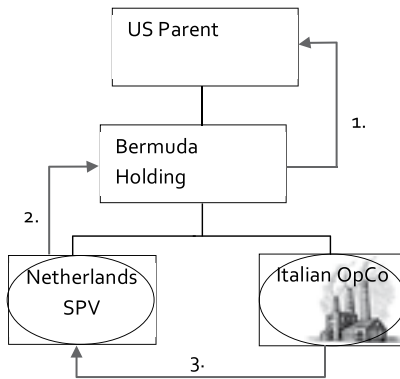
2.3.2.5.1. *Group Structure and Business Model*

In annex C to the Base Analysis Report on Base Erosion and Profit Shifting the OECD also published three examples of aggressive tax planning structures. In two of these a CCA was used to allocate the effective ownership of intangibles to a group company in a low tax jurisdiction. One example was clearly inspired by the Foxtrot case study discussed above. The other concerned a set-up with legal entities in countries referred to as countries A, B, C and D.⁷⁶ This could very well have concerned an MNE from the US (country A) that routes its investment in for example Italy (country D) via Bermuda (country B) and the Netherlands (country C). The structure would work as follows:

Assume a US company intends to start manufacturing and selling products on the southern European market through its Italian subsidiary. In order to limit its overall tax burden it first incorporates a Bermuda intermediate holding company with which it concludes a CCA. Under the agreement the Bermuda company pays a buy-in for pre-existing intangibles and pays a pro rata share of future

⁷⁶ OECD, "Addressing Base Erosion and Profit Shifting", 12 February 2013, page 76 – 79.

R&D expenses. As such it becomes the effective owner of a significant part of the group's intangibles and is entitled to profits stemming from these intangibles. When the cost sharing arrangement is entered into at an early stage, at least before the group developed a track record of sales in southern Europe, the buy-in payment can be kept relatively small. The Bermuda company holds two subsidiaries. These are the Italian operating company and a Dutch special purpose vehicle ("SPV"). The Bermuda holding company licenses out the right to use the intangibles to the Dutch SPV, which in turn sub-licenses that right to the Italian operating company. In return the Dutch SPV pays a royalty to the Bermuda holding and the Italian operating company pays a royalty to the SPV.



1. Buy-in payment for the use of pre-existing intangibles and cost sharing payments for ongoing R&D activities
2. Royalties for the use of intangibles
3. Royalties for the use of intangibles

Figure 5: "OECD BEPS Example"

2.3.2.5.2. Tax Treatment

In Italy the tax deductible royalty erodes the taxable base, leaving only a small part of the profit from operational activities subject to Italian taxation. Under the EU Interest and Royalty Directive there is also no Italian withholding tax payable on the royalty payment to the associated Dutch group company. The Dutch company meanwhile reports the royalty received as taxable income, but at the same time treats the royalty paid to Bermuda as a deductible expense. On balance only a limit spread is subject to Dutch corporate income tax, while the Netherlands under national law does not impose a withholding tax on outbound royalties. To further facilitate the taxpayer, the size of the Dutch taxable income might be confirmed in a tax ruling from the Dutch tax authorities providing

upfront certainty that the structure will work. In Bermuda there is no corporate income tax imposed on the royalty receipts. By having the Dutch and Italian company elect a disregarded status for US tax purposes, the royalty payments are not recognized under the US CFC legislation. In fact for those purposes the active business operations in Italy would be attributed to the Bermuda company, leaving none or almost no CFC income taxable with the parent company in the US.

2.3.2.5.3. Author's Analysis

Like the US case studies the OECD's example illustrates how a CCA can be used to shift future profits to a low tax jurisdiction like Bermuda. The group company located there has limited substance and its only contribution to the development of the intangible assets consists of funding a proportionate share of the development costs. Again two critical elements of the traditional tax treatment of CCAs are in play: the access of low substance group companies to participate in the CCA and the undervaluation of contributions in kind by valuing development activities at cost instead of at market price. The structure would not have the desired effect, if the corporate income tax in the country where intangibles are developed, in this case the US, is replaced by a withholding tax in the country where they are exploited, in this case Italy. The OECD's example shows how this last hurdle can easily be taken by means of so called treaty shopping. The taxpayer simply inserts into the structure a flow-through company located in a country that is satisfied to tax only a small spread on in- and outbound royalties and has a good treaty network, in this case the Netherlands. When the Italian operating company now pays the royalty to the Netherlands, this is exempt from withholding tax under the EU Interest and Royalty Directive. When on its turn the Dutch SPV forwards most of the royalty to Bermuda, the Netherlands under its national law does not impose any additional withholding tax either.

2.3.3. Demarcation Lines

2.3.3.1. Distinguishing between Legitimate Business Practices and Tax Avoidance

After investigating the non-fiscal business rational for implementing CCAs in Paragraph 2.3.1 and considering some examples of their more tax driven application in aggressive tax structures in Paragraph 2.3.2, the question arises how acceptable legitimate and non-acceptable abusive applications can be effectively distinguished. In that context it should be observed that all tax related behavior can generally be qualified along a gradual scale. On the one far end of the spectrum there is tax evasion. This type of behavior conflicts with tax legisla-

tion, it is illegal and it can be challenged in front of a court of law potentially with punitive action as a consequence. On the other far end of the spectrum there is behavior that is undisputedly accepted as legitimate business practice. That type of behavior clearly complies with both the letter and the objectives of tax law. It is commonly regarded as prudent and responsible behavior. In between these two outer limits of the scale is a grey area with a wide range of behaviors that reduce a taxpayer's tax bill and that clearly stay within the boundaries set by the letter of the law, but that at the same time can be argued to conflict with the objectives of the law. If the latter is indeed the case, this type of behavior can be qualified as tax avoidance. As such, tax avoidance has been defined by Prebble and Prebble as "*contriving transactions and structures that reduce tax in ways that are contrary to the policy or spirit of the legislation*"⁷⁷. Since the OECD's BEPS project tax avoidance is more or less synonymous to base erosion and profit shifting.

The identification of a conflict with the spirit of the law and the consequential qualification of certain behavior as tax avoidance has a subjective element to it. It is also a matter of morality and to some extent it is an arbitrary call. To be clear about that: An analysis of these complex and abstract aspects goes beyond the scope of my research and will not be performed in the remainder of this thesis. Alternatively I refer the reader to the many different publications on the topic in both fiscal and non-fiscal literature. However, a practical distinction found there that I would still like to point out, is that between exogenous and endogenous tax avoidance.⁷⁸ Exogenous tax avoidance refers to "*avoidance of tax by resorting to transactions or structures for their own sake, that is, to transactions and structures that are independent of other economic activity of the taxpayer*". Endogenous tax avoidance concerns "*avoidance that is affected by adjusting transactions and structures that the taxpayer was proposing to enter, or has already entered, in any event*". I would argue that in a transfer pricing context exogenous tax avoidance should in principle be countered by the underlying principles of the arm's length standard, as set out in Chapter 3. These make the pricing and even the recognition of intercompany transaction dependent on their economic substance. Similarly tax avoidance through transfer pricing manipulation should be battled by enhanced international consensus and clearer guidance on the application of the principle based arm's length standard. In case of CCAs two very concrete examples of such measures would be the inclusion in the OECD Transfer Pricing Guidelines of the requirement for participants to control the risk associated with the cost shared activities (Paragraph 5.3.2) and the more extensive wording on

⁷⁷ Prebble and Prebble, Creighton Law Review 2010/3.

⁷⁸ Idem.

the valuation of contributions at market price (Paragraph 5.5.3). The problem with endogenous tax avoidance on the other hand is that it does not per se conflict with rules and regulations or the economic substance requirements of the arm's length standard. The appropriate measure against this type of tax avoidance would be an anti-abuse rule, either targeted or general, depending on the type of tax avoidance at hand. A traditional example could be so called controlled foreign company rules aimed at keeping MNEs from parking profitable mobile assets such as high value intangibles in low tax foreign subsidiaries. These rules are discussed in more detail in Chapter 9.

2.3.3.2. Categorization Model

Coming back to the application of CCAs, it should be mentioned that their justification as a safe haven to avoid valuation issues has been challenged by scholars. Brauner for example has argued:

*"Cost sharing, a technique exclusive for the development of intangibles, has strangely evolved, with little evidence of educated policy justifications, within our transfer pricing regime functioning as a safe harbor regime, yet supposedly fully subjected to the discipline of the dominant arm's length standard."*⁷⁹

However, as explained in Paragraph 2.3.1 more legitimate reasons may still exist for the use of CCAs. At the same time it cannot be denied that the arrangements also facilitate aggressive tax planning and even tax avoidance. Establishing the motives for the choice of MNEs to implement a CCA in practice can be difficult and, as explained above, qualifying the use of the CCA as legitimate or abusive is an arbitrary call. Without trying to draw a hard line, I would like to propose a categorization model that in my opinion can facilitate an analysis of the application of CCAs in practice and can help to identify situations where there is an increased risk of base erosion and profit shifting. The proposed categorization model is based on the assumption that there are two aspects that have been particularly decisive for how MNEs have used CCAs to structure the intragroup development of intangibles: the role of intangibles in the value chain and the company's organizational structure.

In relation to the role of intangibles in the value chain Keates, Muylle, Reichert and Wright have already argued that CCAs are traditionally applied in two different ways:

79 Brauner, Intertax 2010/11.

1. They have been used by mostly innovative, high-tech companies to develop high value intangibles and make those available to their foreign subsidiaries, and
2. They have also been used by mostly old-line, low-tech manufacturing companies to develop incremental improvements to existing technologies and share the costs of doing so among their manufacturing sites.⁸⁰

The distinguishing factor here is the relative importance of R&D and marketing for an MNE's operations. That importance is high, if technology, brands or similar intangibles are the fundament of a company's entire enterprise to the point that they offer the company its right to operate. These industries generally revolve around new, original intangibles, hereafter referred to as "*innovative intangibles*". In contrast, the role of intangibles in the company's value chain is less crucial, if those intangibles only marginally improve an existing product, production process or brand image. These intangibles are less the core of the MNE's business, but rather an efficiency factor. They are hereafter referred to as "*incremental intangibles*". Stereotype examples of MNEs using innovative intangibles would be found in among others the pharmaceutical industry and the software and internet industry. It concerns companies that produce specialty products or services, for which customer demand exists because of specific functionalities of the products that outperform available alternatives. The R&D efforts of these companies will often involve "*greenfield*" research aimed at the development of completely new products. As an example of an MNE using incremental intangibles one could think of a bulk chemicals manufacturer. Its products are more a commodity instead of a specialty product and its customers select suppliers on the basis of price instead of functional performance. Its R&D effort will often target cost savings through process improvements. However, it

⁸⁰ Reichert and Wright, International Transfer Pricing Journal 2006/1 and Keates, Muylle and Wright, International Transfer Pricing Journal 2009/3.

should be kept in mind that this observation cannot be turned around to assume that all process intangibles are merely incremental intangibles.⁸¹

The second aspect to take into account when categorizing the use of CCAs then is the organizational structure of the MNE at hand. As already acknowledged in the introductory paragraph of this chapter, centralization of activities, including intangible development activities, can offer synergy benefits and economies of scales. At the same time there will inevitably be a certain distance between the central teams and the business units that have to apply the results of the centralized activities in daily practice. This can create a tension and raise the question what level of centralization leads to optimal performance. In today's globalized world it is in my opinion very unlikely that an MNE would be at one of the outsides of this spectrum by either completely centralizing or decentralizing its development activities. Instead, in most cases there will be some, but not complete, centralization. Its level can differ significantly from time to time and case by case.

The proposed categorization model divides up the application of CCAs into four categories based on the two aspects referenced above; the innovative nature of the developed intangibles and the level of centralization of the development activities. The model is depicted in the following categorization chart:

81 Already in the 1970s Abernathy and Utterback described how common patterns can be recognized in how companies and industries move from radical, innovation to evolutionary incremental improvements (see: Abernathy and Utterback, *Technology Review* 1978/7). They acknowledged that, although there is often emphasis on product innovations, radical process and productivity improvements may have equal or even greater commercial importance. The most famous example illustrating this is the Ford Motor Company, established in 1903. During its first years it developed, produced and sold different model cars with engines ranging from two to six cylinders. In 1908 the experience gathered resulted in a single dominant design, the Model T Ford. Although this undeniably was a technologically advanced automobile for its time, it was only made into an unprecedented commercial success after the factory in which it was produced was reorganized along a single assembly line. The cost savings in which this innovative manufacturing process resulted made the Model T Ford affordable to the larger public. Without any fundamental technical innovations being applied to the design during the next 19 years Henry Ford sold more than 15 million of these cars.

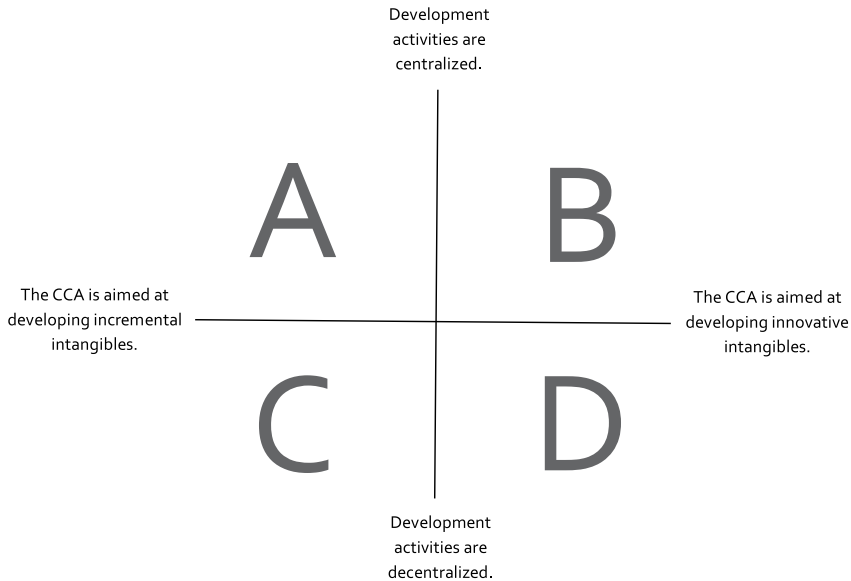


Figure 6: "CCA Categorization Model"

In the north-western quartile "A" one would find the CCAs of companies that predominantly use incremental intangibles developed by centralized R&D or marketing teams. This could concern for example the old-line, low-tech manufacturing companies referenced by Keates, Muylle, Reichert and Wright. Their centralized R&D team may focus on debottlenecking and efficiency improvement of existing production processes. It might regularly visit local manufacturing sites, but generally works at a central location and then makes the know-how and technology developed available to all group members. Alternatively the work could very well be performed in parallel by engineers on various manufacturing sites sharing experience and best practices among themselves. In this case, the CCA would end up in the south-western quartile "C". The north-eastern quartile "B" includes CCAs aimed at the development of innovative intangibles by centralized organizations. Occasions to implement such CCAs are not uncommon, as the development of innovative intangibles generally involves highly specialized R&D work, which is most effectively performed by uniquely experienced teams centralized in only one or a limited number of locations. When accurately delineating the intercompany transactions under these CCAs (also see Paragraph 3.3.1), it is important to note that only one or a limited number of participating group companies are uniquely positioned to perform the functions that result in the development of high value intangibles.

This is less the case, if the performance of development activities is more evenly shared between participating group companies. In that situation the CCA moves into the south-eastern quartile “D”. This could for example occur in case of ring-fenced research projects with a limited number of participants, each of which performs a reasonable amount of R&D activities. In such case the contributions in kind of different participants would be more equally balanced out.

If the CCA is aimed at developing innovative, high value intangibles the valuation of contributions consisting of pre-existing intangibles or the performance of development activities will become more relevant (see Paragraph 5.5.3). If development activities are strongly centralized, it would be less likely that a low substance participant exercises sufficient control over the risks associated with the cost shared activities to participate in the CCA (see Paragraph 5.3.2). Most notably CCAs allocated to the north-eastern quartile “B” of the categorization chart would therefore be in the danger zone. Not surprisingly the CCAs used by the Bravo, Echo and Foxtrot Company from the 2010 Report by the US Joint Committee on Taxation all appear to fit into this category. With those CCAs there should thus be careful consideration of which group companies participate in the arrangement, what the terms and conditions of their collaboration are and what therefore should be the appropriate tax and transfer pricing treatment of their transactions. However, the purpose of the categorization exercise under the model presented above is not to label the transfer pricing outcome of certain CCAs as per se conflicting with the arm’s length standard. It is also explicitly not intended to rule out CCAs as a possible arrangement for the collective performance of R&D or marketing activities by innovative and centralized groups in the far north-eastern quartile “B”. Therefore, if all further requirements for implementation of a CCA are met but the outcome is not at arm’s length, tax authorities should not disregard the legal agreement, but should seek to correct the outcome through pricing adjustments, i.e. through revaluation of the various contributions by participants under the CCA. They might start by assessing whether the contributions of participants housing the R&D and marketing centers, both their pre-existing intangibles and the ongoing functions performed by these participants, are appropriately compensated. Testing this may logically involve a comparison of the outcome with that of the taxpayer’s best realistically available alternative to cost sharing, as also advocated in the US Cost Sharing Regulations.⁸² For a company with a uniquely experienced and skilled R&D or marketing team such alternative would be to develop its knowhow, technology, brand and trademarks or other intangibles at its own

82 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(g)(4)(i)(A) – Also see Paragraph 4.3.3.2.

account and for its own risk and then license them out in return for an appropriate royalty. Obviously there should not be a material deviation in the net present value of the outcome of the CCA structure and the realistically available alternative. If there is, then a pricing adjustment seems in order. However, as long as other requirements for concluding the CCA are met (including those that all participants expect a mutual benefit from the cost shared activities and each of them control the risk associated with those activities), the legal arrangement should be respected. At the same time taxpayers that have strongly centralized development activities, after taking the commercial and financial relationship between the group companies involved into account, may also recognize upfront that a licensing model offers a better fitting, easier to benchmark and more transparent solution. Such taxpayers might then opt for that alternative from the beginning and not use a CCA at all.

Having noted the above, the categorization model is intended to facilitate a full transfer pricing analysis of transactions under a CCA, including their accurate delineation, a comparability analysis and eventually their pricing. It can also help to identify those situations where there is an increased risk of tax avoidance and in respect of which additional attention should be paid to the terms and conditions of the arrangement as well as its tax treatment. When in the following chapters the tax aspects of CCAs are further discussed, I will on occasion reference how this categorization model could in my opinion accommodate a structured analysis.

2.4. Conclusions

The key findings of this Chapter 2 are as follows,

In respect of CCAs as a concept:

- (i) The arrangements that are the subject of this research are generally concluded between companies belonging to the same multinational group, but they are not commonly agreed between unrelated enterprises. This reality is caused by fundamental differences in the factual position of related and unrelated companies, most notably a lack of conflicting competitive interests among the former. As that explains why it can still be a rational business decision for related companies to enter into those arrangements, CCAs should nonetheless be considered an acceptable instrument for structuring the joint development of tangible or intangible assets or for obtaining intercompany services. In fact, they have been recognized as such for more than half a century.

- (ii) The most relevant publications since the nineteen sixties can be set out along a timeline as follows:

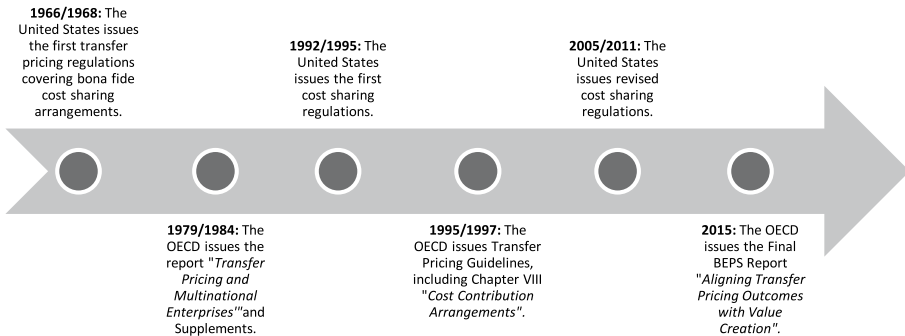


Figure 7: "Timeline of Most Relevant Rules and Regulations"

- (iii) The United States Treasury introduced bona fide cost sharing arrangements in 1966 as a safe haven for taxpayers to avoid valuation issues in respect of intangible property. The reasoning behind this is that by foreseeing in the collective ownership of intangibles CCAs offer group companies free access to those intangibles and thereby limit the necessity to transfer or license them out, avoiding the valuation issues inherent to the latter type of transactions.
- (iv) Following the US lead, the OECD adopted the concept of cost contribution arrangements in 1979 and since then provided updated guidance on several occasions. However, from the very start it used its own terminology and took a position that materially deviated from the US approach in respect of some aspects. Most critically this included the matter of whether or not a profit mark-up should be included in the value of CCA contributions. While the US Cost Sharing Regulations have continuously allowed for a valuation at cost of most contributions, the OECD prefers such valuation to include a profit element. It quite explicitly reinstated its position on this in the 2015 Final BEPS Report.
- (v) Traditionally both the US Cost Sharing Regulations and the OECD Transfer Pricing Guidelines displayed little concern about the use of CCAs in tax avoidance structures. The first sign of a shift in thinking can be found in the 1997 version of Chapter VIII of the OECD Transfer Pricing Guidelines, which acknowledge that the arrangements could potentially result in an over-

statement of income in some countries and therefore require taxpayers to be prepared to substantiate their claim with respect to CCAs. By 2013 the impression that CCAs were being used as a tax avoidance tool had clearly grown, when the OECD considered it necessary to include a revision of Chapter VIII of the Transfer Pricing Guidelines in its Action Plan to tackle base erosion and profit shifting.

In respect of the legal status of CCAs:

- (i) CCAs can be defined as contractual joint ventures that are not regarded partnerships. This status has certain legal implications: Participants have the freedom to choose the law of which jurisdiction governs the agreement, while their liability to third parties is limited. At the same time CCAs do not constitute separately taxable entities. Instead participants are taxable individually in respect of their profits from cost shared activities.

In respect of the application of CCAs in fiscal practice:

- (i) When considering the application of CCAs in fiscal practice it should first be noted that there are at least five type of legitimate business reasons for MNEs to implement CCAs. The arrangements facilitate a free flow of expertise and knowledge, allow for cross company risk sharing, help to avoid the complexity associated with separate intercompany transfer of intangibles, bring administrative simplicity and offer upfront certainty and consistency in respect of the group's transfer pricing approach.
- (ii) At the same time CCAs are also known to facilitate tax avoidance structures. The examples included in the Report by the US Joint Committee on Taxation and the OECD Committee on Fiscal Affairs show that there are two specifically problematic issues in respect of the traditional tax treatment of CCAs. The first is that it allows for group companies with limited substance to participate in the arrangements (identified as the main issue in the Bravo and Foxtrot case studies in Paragraph 2.3.2.1 and 2.3.2.3). The second is the underappreciation of contributions in kind by valuing these at cost price instead of market price (identified as the main issue in the Echo case study in Paragraph 2.3.2.2).
- (iii) The aforementioned examples further illustrate that the use of CCAs in tax avoidance structures is not effectively restricted by traditional anti-abuse rules. In the US for example, the freedom for taxpayers to opt for tax transparent treatment of subsidiaries at their own discretion and the wide range

of exceptions offer taxpayers ample opportunity to avoid the application of CFC legislation. Furthermore, there can be concerns about the possibility for taxpayers to avoid source state taxation on royalty payments to a low substance group company by routing such payments via a pass-through subsidiary in a tax jurisdiction with the right tax treaty network and a cooperative tax administration.

- (iv) When performing a tax and transfer pricing analysis of a CCA in practice it can be helpful to categorize such application depending on the innovative nature of the intangibles developed under the arrangements and the level of centralization of development activities (see the categorization chart included in Paragraph 2.3.3.2). The profit shifting potential of CCAs becomes specifically apparent, when CCAs are used to place the ownership of centrally developed, innovative intangibles with foreign affiliates of minimal substance that are located in a low tax jurisdiction. In other words, there is an increased risk of tax avoidance when it concerns CCAs in the north-eastern quartile "B" of the categorization chart.

Part 2: Transfer Pricing Aspects

3. General Transfer Pricing Considerations

3.1. Introduction

Transfer pricing is about the pricing of transactions between associated enterprises. It can concern the supply of goods or provision of services as well as transactions involving intangible assets. Transfer pricing is relevant from a tax perspective, because it determines how profits are split between group members of an MNE in different tax jurisdictions. Thus it determines which group company has to pay tax on those profits. If an MNE uses inappropriate transfer prices, sometimes also referred to as transfer mispricing, this is generally considered a justification for tax administrations to make profit adjustments, for example by disallowing a deduction for certain costs or by imputing additional income. Without a corresponding adjustment of the taxable income of the other party to the intercompany transaction, that would result in two different group companies paying tax on the same profit. This is referred to as economic double taxation.⁸³ In order to effectively avoid economic double taxation an international consensus on how to establish transfer prices in cross-border transactions is required.⁸⁴

This Chapter 3 includes some introductory considerations about those current transfer pricing practices that are relevant for a further in-depth analysis of the position of CCAs. First Paragraph 3.2 discusses the legal basis for the so called arm's length standard and considers the status of the OECD's Transfer Pricing Guidelines as a means to its interpretation. It references the long ongoing discussion about the impact of changes in the Commentary to the OECD Model Tax Convention and establishes how that plays a role when qualifying the recent amendment to the guidance on CCAs under the OECD's BEPS-project. Next Paragraph 3.3 looks in more detail at the so called comparability analysis, which is to be performed when pricing intercompany transactions. It also considers the relevance of risk assumption in that context, specifically risk assumption by

83 Economic double taxation is different from juridical double taxation, which is further elaborated on in Paragraph 8.1.

84 Compare also Paragraph 12 of the Preface of the OECD Transfer Pricing Guidelines.

cash box entities participating in a CCA, and addresses the general complexity of pricing transactions governed by a CCA. Paragraph 3.4 then considers the possibility for tax administration to disregard the legal arrangements between associated enterprises and to make so called transactional adjustments. It also further explains why CCA contracts between group companies should principally be respected, even though materially similar arrangements are not found frequently between unrelated parties.

3.2. The Arm's Length Standard

3.2.1. Legal Basis

The global standard for setting prices of intragroup transactions, including transactions under a CCA, is the so called arm's length standard ("ALS"), often referred to as the arm's length principle. This is based on the fundamental assumption that transfer prices should be determined by comparing intercompany transactions with transactions between unrelated enterprises. An arm's length transfer price is the price that third parties would be prepared to pay on the open market for a comparable transaction under similar circumstances or, as Wittendorff worded it:

"The arm's length principle involves a valuation of controlled transactions where the yardstick is market transactions."⁸⁵

Over the years the United States has been an advocate of the use of the ALS as a global transfer pricing standard. Under US tax law its legal basis originates from Section 482 of the Internal Revenue Code, which states the following:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B)), the income with respect to

85 Wittendorff 2010, page 7.

such transfer or license shall be commensurate with the income attributable to the intangible."

Notably the Internal Revenue Code does not define an allocation norm. However, under the mandate provided by the Code to the US tax administration, the US Transfer Pricing Regulations adopt the ALS:

"In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."⁸⁶

The US Court of Appeals for the Ninth Circuit further confirmed that the ALS was the readily understandable international measure for profit allocation among affiliated enterprises in the Xilinx case. This case will be discussed in detail in Paragraph 4.4.2.

Backed by the United States the ALS has become the most commonly accepted profit allocation standard of international tax law. As such it is applied in the OECD Model Tax Convention, which includes the authoritative statement of the ALS in Article 9:

"Where ... conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."⁸⁷

This restricts contracting states, so that they cannot include any profits in the taxable income of a resident enterprise in excess of the profits that would have been allocated to his enterprise in third party situations. If on the other hand a contracting state appropriately includes profits in the taxable income of a resident under this provision, the article requires the other contracting state

86 US Transfer Pricing Regulations, §1.482-1(b)(1).

87 OECD Model Tax Convention, Article 9, Paragraph 1.

to make a corresponding adjustment to the tax that it charged from the other party to the intercompany transaction.⁸⁸

The ALS is also adopted as an allocation standard in other model tax conventions, including the model tax convention of the United Nations as well as most of the bilateral tax treaties currently in force. Furthermore, it is mandatorily applied by the contracting states of the EU Arbitration Convention.⁸⁹ Taken all this into account it seems justified from an objective perspective to regard the ALS as the customarily accepted allocation standard. However, that does not mean that application of the ALS is a legal requirement under international customary rule ("*opinio juris*"). For it to qualify as such, a subjective condition would also still have to be fulfilled. That means that there would have to be a certain belief among states that they are bound by international law to use the ALS in all allocation matters. However, this belief does not appear to exist. To the contrary, every so often a debate about alternative allocation norms is re-activated. Specifically so called formula based apportionment has frequently been suggested as an alternative norm. This would involve an indirect allocation of taxable income on the basis of a specific allocation key or multiple specific allocation keys, for example turnover, number of employees or balance sheet value. It has also been argued that in fact the ALS and formula based apportionment are not two distinct and unrelated concepts, but that instead they represent the extreme ends of a transfer pricing continuum. In that view the only true arm's length pricing is achieved by applying the comparable uncontrolled price method, followed at close distance by the cost plus or resale minus methods. Via the various profit split methods one eventually gets to the allocation of consolidated group profits according to a prefixed allocation key referred to as formula based apportionment.⁹⁰

According to the Transfer Pricing Guidelines however, the OECD Member States reject formula based apportionment.⁹¹ Nevertheless, in the United States and Canada the method is applied to allocate corporate profits among states, while

88 Both these adjustments are referred to as primary transfer pricing adjustments. They correct the taxable income of taxpayers to reflect arm's length pricing. They do not however address the issue of remittance of the difference between the applied incorrect transfer price and the arm's length transfer price. Although that is not arranged for in the OECD's Model Tax Convention, some countries will therefore supplement primary adjustments with so called secondary adjustments. The latter adjustments seek to effectuate the cash impact of amending the transfer pricing. For example, when a transfer price was too high the state of the paying entity might, as a primary adjustment, impute additional taxable income and then, as a secondary adjustment, recognize a dividend distribution to the shareholder.

89 Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of transfers of profits between associated undertakings (EU Arbitration Convention), Article 4.

90 Avi-Yonah 2007.

91 OECD Transfer Pricing Guidelines, Paragraph 1.32.

the European Union has been investigating for several years whether it would be possible to apply an indirect allocation norm under a Common Consolidated Corporate Tax Base (CCCTB) among its Member States.⁹² True, the European Commission has also argued in several recent state aid cases that EU Member States are bound to apply the arm's length standard, as they would otherwise be in breach of Article 107 of the Treaty on the Functioning of the European Union, granting state aid to the benefitting taxpayers. However, as explained in the Commission's decisions, that would only be the case because these countries use the corporate accounting profit as a starting point to calculate a taxpayer's tax base.⁹³ If under those circumstances they allow taxpayers that are part of a multinational group to deviate from commercial prices in intercompany transactions, those taxpayers would be able to erode that tax base and that would provide them with an unacceptable selective advantage.⁹⁴ Nevertheless, EU Member States can, at least theoretically, still deviate from the arm's length standard, as long as they then somehow ensure that the tax base for all taxpayers (controlled and uncontrolled) is established in a consistent manner.

In light of the foregoing, formula based apportionment should at the very least be considered a legitimate alternative to the ALS. Wittendorff has made a similar analysis and concluded:

*"... the arm's length principle cannot be assumed to qualify as customary international law. This means that Article 9(1) does not have a special status in international law, since the OECD Model and Commentary in general are not regarded as being customary international law."*⁹⁵

While Wittendorff subsequently continues to refer to the "arm's length principle", it is in my opinion more accurate to consequently use the term "arm's length standard" instead and I have therefore chosen to do so throughout the rest of this study.⁹⁶

92 Press release of the European Commission, 16 March 2011, IP/11/319.

93 See for example: European Commission, Decision (EU) 2017/1283 on state aid implemented by the Netherlands to Starbucks, 21 October 2015, OJ L83/38 and European Commission, Decision (EU) 2017/502 on state aid implemented by Ireland to Apple, 30 August 2016, OJ L187/1.

94 That leaves open the question whether the disputed rulings in the state aid cases did or did not comply with the arm's length standard. With Member States currently disagreeing about this with the Commission, that will have to be determined by the European Court of Justice.

95 Wittendorff 2010, page 290.

96 It should be noted that other scholars have reached different assertions about the legal status of the arm's length concept. Dwarkasing, for example, after an extensive examination of its history concludes that it is in fact "a general principle of international taxation" (Dwarkasing 2011).

3.2.2. Interpretation

In the Commentary to Article 9 of the OECD Model Tax Convention the conditions that would have been made between independent enterprises are referred to as “*arm’s length terms*”. The Commentary further claims that the OECD Transfer Pricing Guidelines represent internationally agreed principles for determining arm’s length terms and indicates that those Guidelines, including Chapter VIII on CCAs, provide additional guidance on the application of the ALS.⁹⁷ This makes the Transfer Pricing Guidelines an integral part of the Commentary. As such, they have an important role to play in the interpretation of tax treaties and the application of the ALS in practice. However, the legal status of the Commentary is disputed and the uncertainty in which that results automatically also affects the legal status of the Transfer Pricing Guidelines.

The interpretation of tax treaties is governed by the rules set out in the Vienna Convention on the Law of Treaties (VCLT). Article 31 of the VCLT provides for the primary means of interpretation. It prescribes that treaties should be interpreted in good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in light of its object and purpose (Paragraph 1). For interpretation purposes the context of the treaty is subsequently defined as any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty or any instrument which was made by one or more parties in connection with the conclusion of the treaty and then accepted by the other parties as an instrument related to the treaty (Paragraph 2). As an alternative to an interpretation based on context or object and purpose, a special or technical meaning can be given to a term, but only if that is what the parties have intended (Paragraph 4). Article 32 subsequently provides for so called supplementary means of interpretation. These have a more limited role, as they can only confirm the meaning as interpreted under Article 31 or help determine that meaning, if the primary means of interpretation leave the meaning of a term “*ambiguous or obscure*” or lead to a result that is “*manifestly absurd or unreasonable*”.

There appears to be consensus among scholars that the OECD Commentary is not a binding legal agreement under international law.⁹⁸ This is also confirmed by the introduction to the Commentary itself, which states:

97 Commentary to Article 9 of the OECD Model Tax Convention, under 1.

98 Vogel, Bulletin for International Taxation 2000/10, Engelen 2004, page 459 and Wittendorff 2010, page 123.

"The Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments."⁹⁹

As such the Commentary is not part of the context of the treaty as defined in Paragraph 2 of Article 31 of the VCLT. It has been argued however that the Commentary, as it existed at the time the treaty was concluded, reflects a common international tax language that provides for the ordinary meaning of the terms of the treaty under Paragraph 1 of Article 31¹⁰⁰ or for a special or technical meaning of a term under Paragraph 4 of Article 31¹⁰¹. Others consider the OECD Commentary a supplementary means of interpretation under Article 32.¹⁰² The High Court of Australia came to the latter conclusion in the Thiel case:

"Whilst the Model Convention and Commentaries may not strictly amount to work preparatory to the double taxation agreement between Australia and Switzerland, they are documents which form the basis for the conclusion of bilateral double taxation agreements of the kind in question and, as with treaties in pari materia, provide a guide to the current usage of terms by the parties. They are, therefore, a supplementary means of interpretation to which recourse may be had under Article 32 of the Vienna Convention."¹⁰³

The various views outlined above have in common that they all consider the Commentary, as it existed at the time the treaty was concluded, an authoritative means of interpretation. The next question that comes up is what the impact is of additions or changes to the Commentary introduced subsequent to the conclusion of the treaty. Ward answers this question by distinguishing different types of additions and changes to the Commentary.¹⁰⁴ The first type only amplifies the existing Commentary by adding examples or supplementary arguments. These explicatory additions are given similar weight as the existing Commentary. They differ from a second type of additions, which provides guidance that was not previously included without contradicting with the existing Commentary. According to Ward *"such gap-filling Commentary should be viewed with great care by treaty interpreters, particularly domestic courts, to determine whether it has any legitimate role in the interpretative process"*. Finally, there may

99 Commentary to the OECD Model Tax Convention, Introduction Paragraph 29.

100 Wittendorff 2010, page 124.

101 Ward, Bulletin for International Taxation, 2006/3.

102 Engelen 2004, page 460 and Lang and Brugger, Australian Tax Forum 2008/2.

103 Thiel v. Federal Commissioner of Taxation, (1990) 171 CLR 338, 22 August 1990.

104 Ward, Bulletin for International Taxation 2006/3.

be outright changes made to the Commentary that reverse the Commentary as it existed at the time a treaty was concluded. It appears logical that this third type of changes can never play a legitimate role in the interpretation of pre-existing tax treaties.

The foregoing imposes a certain restriction on the effectiveness of any change to the Transfer Pricing Guidelines. If such change conflicts with the previous version of the Transfer Pricing Guidelines, then it would only take effect after the pre-existing tax treaties have also been amended. This was however not explicitly acknowledged by the OECD, when it announced that there might be so called special measures deviating from the ALS included in the Transfer Pricing Guidelines as a key part of its 2015 anti-BEPS proposals.¹⁰⁵ In this context it should also be pointed out that, after the BEPS project's Final Reports were issued, more than 100 countries entered into a multilateral instrument to modify over 2,000 existing bilateral tax treaties.¹⁰⁶ This instrument implements a number of the agreed measures, predominantly targeting tax treaty abuse. However, it does not in any way address the position of Article 9 of existing tax treaties or the impact of changes in the Transfer Pricing Guidelines on the interpretation of the ALS. Perhaps it was a deliberate decision of the OECD's Committee on Fiscal Affairs to limit the scope of the multilateral instrument to increase chances of reaching a political agreement about it. Although that would be very understandable, it means that the earlier referenced uncertainty about the legal status of changes to the Transfer Pricing Guidelines remains.

When it comes to the transfer pricing treatment of CCAs, there are at least two relevant changes to Chapter VIII of the Transfer Pricing Guidelines in respect of which the foregoing justifies a further analysis. The first is the introduction of the control-over-risk requirement, under which all participants of a CCA need to exercise control over the risks associated with the business opportunity presented by that arrangement. The second is the new wording that requires all contributions under a CCA to be valued at market price. Both these requirements were not explicitly mentioned in the previous version of Chapter VIII of the Transfer Pricing Guidelines nor were they routinely applied in practice by all OECD Member States. In fact, a very important Member State, the US, traditionally accepted cash box entities with insufficient substance to control risks as a participant and allowed for current contributions to be valued at cost. As such, the two new requirements could be viewed upon as what Ward would call "*gap-fillers*", making their role in the interpretation of existing tax trea-

105 OECD/JG20, "*Aligning Transfer Pricing Outcomes with Value Creation*", 5 October 2015.

106 OECD/JG20, "*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*", 24 November 2016.

ties debatable. However, as will be explained in Paragraph 3.3.1.2, 5.3.2.2 and 5.5.3.5, both requirements are the logical consequence of the more general aim of the ALS to apply open market conditions in controlled situations. They should in my opinion therefore not be regarded “gapfillers” but instead be considered mere clarifications of the ALS. As such, they have the same legal status as any other requirement following from earlier versions of the Transfer Pricing Guidelines and they should also apply under Article 9 of pre-existing tax treaties based on the OECD Model Tax Convention.

3.3. Comparability Analysis

3.3.1. Delineating Transactions

3.3.1.1. *Commercial and Financial Relations*

The merits of the ALS require a comparison of the conditions of controlled and uncontrolled transactions. Under the OECD's Transfer Pricing Guidelines this comparability analysis consists of two steps. The first is to accurately delineate intercompany transactions, while the second is to compare them with similar transactions between unrelated parties and price them accordingly.¹⁰⁷ The delineation involves the identification of economically relevant characteristics of the commercial and financial relations between the transacting group companies. The contractual terms of the transaction will be a starting point.¹⁰⁸ However, as there is no or only limited divergence of interests between the parties to intercompany transactions, it is very well possible that their actual conduct is inconsistent with the contractual arrangements. Testing whether that is the case involves a so called functional analysis, which examines the functions performed by each of the parties taking into account the assets used and the risks assumed. This is not so much a quantitative test, but rather a qualitative test. The economic significance of the functions that the parties perform in terms of their frequency, nature and value is more important than the number of those functions.¹⁰⁹ As outlined in Paragraph 2.3.3 I believe that when delineating the transactions under a CCA it is helpful to categorize the arrangement based on the type of intangibles developed and the level at which development activities are centralized. Especially when innovative intangibles are developed by centralized teams, it would be quite relevant to determine

107 OECD Transfer Pricing Guidelines, Paragraph 1.33.

108 Idem, Paragraph 1.42.

109 Idem, Paragraph 1.51.

whether all participants actually assume sufficient risk to justify that they are considered full-fledged participants in the intercompany collaboration with a corresponding entitlement to share in future profits and to establish whether their contributions are valued appropriately.¹¹⁰

3.3.1.2. Risk Assumption

The impact of risk assumption on the outcome of the functional analysis was a major focus point of the revision of the Transfer Pricing Guidelines under the BEPS project. Risk is highly mobile, as it can easily be legally transferred between entities. As the assumption of risk may justify a party to a controlled transaction to receive a higher compensation, a legal transfer of risk could facilitate profit shifting. For that reason the OECD has traditionally been concerned about “*contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties*”.¹¹¹ To better address this issue, a new section on the analysis of risks in commercial or financial relations was included in the Transfer Pricing Guidelines.¹¹² This defines risk as “*the effects of uncertainty on the objectives of the business*”.¹¹³ Risk is assumed by a party that bears the up- and downside consequences of the risk and feels the impact, when it materializes. A risk is controlled by the party or parties that make decisions about taking on, laying-off or declining a risk bearing opportunity and that make decisions about how to respond to risk. The controlling party does not necessarily also perform the day-to-day risk management. Alternatively it might outsource such risk mitigation activities to others.¹¹⁴ The OECD explains that unrelated parties would only assume risk, if they exercise control over the risk and have the financial capacity to bear it. It therefore follows from the ALS that, if in a controlled transaction risk is contractually assumed by a party that does not exercise control over that risk or does not have the necessary financial resources to bear it, the risk should be allocated to the associated enterprise or group of associated enterprises that does exercise this control and has such resources.¹¹⁵

In the more aggressive pre-BEPS transfer pricing structures MNEs would take the position that risk had been allocated to a low substance cash box entity in a low tax jurisdiction. The only activity performed by the cash box entity would

¹¹⁰ See the categorization model proposed in Paragraph 2.3.3.2.

¹¹¹ OECD, “*Addressing Base Erosion and Profit Shifting*”, 12 February 2013, page 45 and OECD, “*Action Plan on Base Erosion and Profit Shifting*”, 19 July 2013, page 19 and 20.

¹¹² OECD Transfer Pricing Guidelines, Section D.1.2.1.

¹¹³ Idem, Paragraph 1.71.

¹¹⁴ Idem, Paragraph 1.65.

¹¹⁵ Idem, Paragraph 1.98.

consist of providing financial funding for certain business activities. The Transfer Pricing Guidelines provide an example of such a situation in Paragraph 1.85 and, further on, effectively define a cash box entity as “[a company] *that does not perform functions to evaluate the financing opportunity, does not consider the appropriate risk premium and other issues to determine the appropriate pricing of the financing opportunity, and does not evaluate the appropriate protection of its financial investment*”.¹¹⁶ I would agree with the OECD that a cash box entity cannot exercise control over financial risks. If it contractually assumes such risks, this conflicts with the factual substance of the relations between the parties. That justifies deviating from the contractual arrangements when determining taxable income (also see Paragraph 3.4). For transfer pricing purposes the risks would then be allocated to the other party or parties to the transaction and no risk is left with the cash box entity. By consequence, that entity would be rewarded with nothing more than a risk free return. It is also this inability to control risk that would block a cash box entity’s access to a CCA.

3.3.1.3. *Other Elements*

Besides the contractual arrangements and the actual conduct of the associated parties there are three other elements to observe when delineating associated transactions. The first of these elements concerns the characteristics of the property involved or the nature and extent of services provided. When intangible assets are involved, as will often be the case with CCAs, the type of intangible (patent, trademark or know-how), the duration and degree of its protection and the anticipated benefits from this use would also be relevant.¹¹⁷ However, as will be discussed in more detail in Paragraph 3.3.2.1, determining the anticipated benefits can be a difficult and sometimes arbitrary exercise. The second element consists of the economic circumstances under which the transactions take place. This includes the geographic location of the associated enterprises and related aspects such as size of the local market, the purchasing power of its consumers and its labor costs. These local market features will also play an important role, when in the second step of the comparability analysis the inter-company transactions are to be priced or, in case of a CCA, contributions are to be valued.¹¹⁸ The third and final element relevant for the delineation of inter-company transactions is the business strategy adopted by the associated enterprises. This refers to the strategic choices impacting their day-to-day operations. That can be related to innovation and product development, risk appetite

¹¹⁶ Idem, Paragraph 1.103

¹¹⁷ Idem, Paragraph 1.107.

¹¹⁸ See Paragraph 3.3.2 and 5.5.3.

or market penetration schemes. These aspects may distinguish the nature of a transaction from otherwise comparable transactions. For example a company trying to get foothold in a new market might be prepared to temporarily accept more costs. Under a CCA there would be a case to make that this should then be reflected in the allocation key used to split costs and risks among participants.¹¹⁹

3.3.2. Pricing

3.3.2.1. Transfer Pricing Methods

The second step of the comparability analysis is to select a method for setting an appropriate transfer price for the controlled transactions. If data are available on comparable uncontrolled prices used in transactions under similar circumstances these can be used for reference (the “CUP-method”). It is also possible to base the pricing on the resale price of a product minus a fixed percentage as compensation for the reseller (the “*resale minus method*”) or the costs of a supplier plus a fixed percentage as compensation for the supplier (the “*cost plus method*”). The CUP, cost plus and resale minus method are so called transactional methods. Alternatively a profit split method may be used. Under a so called one-side profit split method the net margin on an intercompany transaction of one party is determined on an appropriate basis, for example the tested party’s costs, sales or assets (the “*transactional net margin method*”). In contrast, under a so called two-sided profit split method the overall profit from an intercompany transaction is allocated between the two parties to the transaction considering both parties’ relative position in respect of a certain splitting factor (the “*transactional profit split method*”).

As there are generally limited or no comparables available for CCAs (also see Paragraph 2.2.1), tax administrations have to determine the underlying economic reality behind the arrangement and thus try to establish whether it is likely that the agreed terms would have been acceptable to third parties, should they have concluded the same arrangement under similar circumstances. When testing this, it has to be kept in mind that a CCA is often a package deal covering more than one transaction. It may include the contribution of multiple pre-existing intangibles and the performance of various types of development activities and services. Application of the ALS will further be complicated by the fact that part of the compensation for participants consists of the expected benefits from their individual exploitation of the results from the pooling of resources and skills. All this distinguishes CCAs from an ordinary transfer of property or

¹¹⁹ See Paragraph 5.6.2.

rendering of services and makes it impossible to price the aggregate of transactions under the arrangement using a single traditional transfer pricing method. Instead it will be required to price the different contributions of participants separately and then even these out by means of so called balancing payments, in order to establish a situation under which it can be said that the net contribution after such balancing payments of each participant is proportionate to its expected benefit for the collaboration.

To illustrate how complex this can be, the example can be given of two associated companies that enter into a CCA with one of them contributing pre-existing intangibles that will be used to develop a new product line and both of them performing part of the future R&D work. It is very well possible that the tax administration in the country of residence of the participant contributing the pre-existing intangibles argues that the best way to test the arm's length nature of the compensation for such contribution is to compare it with the net present value of royalties that the pre-existing intangibles could generate under a licensing agreement between unrelated parties. This would, at least theoretically, require the following subsequent steps to be taken:

1. The net present value of the overall compensation of the participant contributing the pre-existing intangibles has to be established using an appropriate discount rate. This compensation can consist of multiple elements: a buy-in payment, balancing payments paid in the course of the CCA and the benefit from the participant's individual exploitation of results.
2. It has to be acknowledged what part of the overall compensation is intended to compensate for the contribution of the pre-existing intangibles and what part is intended to compensate for other contributions by the same participant, like performing R&D activities and assuming development risks.
3. An arm's length royalty for a license to use the pre-existing intangibles has to be determined using one of the traditional transfer pricing methods, for example the CUP method, involving a comparability analysis of its own.
4. The net present value of the hypothetical royalty during the remaining lifespan of the pre-existing intangible has to be calculated using an appropriate discount rate, which should differ from the discount rate used in step 1 in such a way that it appropriately reflects the difference in risk profile between a licensor and a cost sharing participant.

5. The outcomes of steps 2 and 4 have to be compared. A pricing adjustment should only be considered, if the value arrived at under both steps differs materially.

The pricing of contributions under a CCA are discussed in more detail in Paragraph 4.3.3 and 5.5.3.

3.3.2.2. *Comparability Factors*

It should further be acknowledged that there may be certain external elements that impact the conditions that third parties would agree upon for transactions, including those under a CCA. These elements are referred to as comparability factors. They should be taken into account when performing the comparability analysis and they should subsequently be reflected in the applied transfer pricing.¹²⁰ It may concern local market features, assembled workforce and group synergies. Local market features can involve low labor costs, availability of highly skilled personnel, strong purchasing power of potential customers, an above average demand for specific products, favorable weather etcetera. The existence of an assembled workforce has to be reflected in arm's length pricing, if a company has successfully concluded mid or long term employment contracts with a uniquely qualified or experienced group of employees, while group synergies may concern benefits from among others streamlined management, the elimination of duplicated processes, integration of systems or stronger purchasing and borrowing power.

Countries with developing economies are generally focused on whether transfer prices sufficiently compensate for comparability factors. This is caused by a concern that group companies in their jurisdiction may be cut short, especially in respect of local market features. These countries therefore often argue that transfer prices should include a so called market premium. China for example included extensive wording on this issue in the section on its country practice of the UN Transfer Pricing Manual.¹²¹

3.4. **Transactional Adjustments**

A sound comparability analysis followed by an accurate application of an appropriate transfer pricing method should normally lead to an arm's length outcome. If this is not the case, then the preferred solution is a pricing adjustment. It is

120 OECD Transfer Pricing Guidelines, Section D.6. – D.8.

121 United Nations, Practical Manual on Transfer Pricing for Developing Countries (2017), Section D.2.4.4.

explicitly confirmed in the Transfer Pricing Guidelines that every effort should be made to price the actual intercompany transaction before it is disregarded.¹²² The OECD however also adopts a substance over form approach as a measure of last resort. This would be applied, when it has to be assumed the unrelated parties would under similar circumstances not have chosen to enter into the arrangement and it is therefore simply not possible to determine an appropriate pricing or, as it is worded in the Transfer Pricing Guidelines:

*"The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction."*¹²³

If the transaction in itself does not make business sense so that it cannot be corrected through a price adjustment, it is alternatively possible to make a so called transactional adjustment. This could consist of non-recognition or re-qualification of the transaction.

Wittendorff has argued that Article 9 of the Model Tax Convention cannot be interpreted to sanction a substance over form approach and that transactional adjustments are therefore not governed by this article.¹²⁴ Alternatively, the legal basis for transactional adjustments should then be found in domestic anti-abuse rules. This position is based on a reading of Article 9 that recognizes the transactions as an undisputed, fixed point and the conditions of those transactions as the tested element. It is assumed that consequently only these conditions can be adjusted. I disagree with this interpretation. In my opinion it appears more likely that the term "*commercial or financial relations*" used in Article 9 should be broadly interpreted to mean the factual economic reality between the parties and not restrictively read as to refer only to the contractual arrangements between them. An adjustment of the conditions made or imposed in these commercial or financial relations could then in extremis include disregarding

122 OECD Transfer Pricing Guidelines, Paragraph 1.121

123 Idem, Paragraph 1.122

124 Wittendorff 2010, page 152 and further.

the contractual arrangement all together resulting in the non-recognition or re-qualification of transactions.

However, any transaction that is also concluded between unrelated parties should by definition be respected. Furthermore, a transaction that is uncommon between third parties or has simply not been proven to exist between third parties can only be disregarded, if it lacks commercial rational. Determining whether this "*condition sine qua non*" is met in my opinion involves the cumulative testing of two elements: (i) whether there are inherent differences in commercial and economic circumstances between related and unrelated parties justifying a lack of comparables, and (ii) whether the economic outcome of the existing contractual arrangements is or via price adjustments can be influenced such that profits arise where value is created. In other words, the mere fact that a transaction is not found between unrelated parties by itself is insufficient reason to automatically disregard it. This is crucial for the position of CCAs, which would typically be observed more often between associated parties and far less between unrelated parties. Or, as the preamble to the 2005 US Cost Sharing Regulations put it:

*"Comment letters and other information available to the Treasury Department and IRS have provided limited information on third-party arrangements that are asserted to be similar to cost sharing arrangements."*¹²⁵

Nevertheless, as already contested in Paragraph 2.2.1, material differences exist between the commercial and competitive positions of related and unrelated entities, which offer an acceptable explanation for the fact that the overall number of comparable uncontrolled transactions is, at best, very limited. This difference in position makes that for companies belonging to the same multinational group there can be convincing commercial rational to conclude a CCA, while third parties would choose to enter into a joint development agreement with different terms and conditions. Furthermore, it will be argued in the following chapters that the overall outcome of a CCA is by definition such that profits are taxed where value is created, if all contributions by participants in the arrangement are valued at an arm's length price appropriately taking into account assets used, functions performed and risks assumed by those participant for making these contributions. Presuming for the moment that this coherence will be adequately demonstrated hereafter, it should be possible for any tax auditor coming across a specific CCA with a non-arm's length outcome

¹²⁵ Treasury and IRS, 1995 Final Cost Sharing Regulations, 60 Fed Reg 65557 (1995), preamble.

to restore the balance by adjusting the valuation of one or more contributions, while it should not be necessary to resort to the nuclear option of disregarding the underlying contractual arrangement.

It can be said that the second tested element determining whether or not there is a commercial rational (i.e. whether or not an arm's length outcome can be created through a pricing adjustment) in fact reverses the arm's length analysis: It does not look for the correct pricing of an existing contractual arrangement but instead starts at the pricing to decide whether the underlying contractual arrangement should be respected. Be that how it may, this approach upholds the ultimate goal of the arm's length principle to ensure that companies belonging to the same multinational group transact under conditions that third parties would also have accepted under similar circumstances. As such, tax administrations should in principle respect CCA contracts and only contemplate a transactional adjustment in the exceptional situation that the accurate delineation of the transactions evidences that the factual relationship and actual dealings between the parties differ fundamentally from their contractual arrangement. The most likely reason to disregard a CCA then appears to be that one or more of the participants do not have the capacity and resources required to exercise control over the risks associated with the cost shared activities and therefore cannot assume those risks. In other words: A CCA contract could be disregarded, if an empty shell cash box company signs up as a participant and the arrangement should then be replaced by an alternative transaction or set of transactions that results in the income of participants to be adjusted, so that the empty shell cash box company makes no more than a risk-free return.

3.5. Conclusions

The key findings of this Chapter 3 are as follows,

In respect of the legal status of the ALS and the role of the OECD Transfer Pricing Guidelines as a means of its interpretation:

- (i) The ALS is the most commonly accepted standard for profit allocation in international tax law and therefore generally also governs controlled transactions under a CCA.
- (ii) The OECD Transfer Pricing Guidelines are an integral part of the Commentary to the OECD Model Tax Convention and, as such, qualify as an authoritative means of interpretation of the ALS.

- (iii) The most relevant additions to Chapter VIII of the Transfer Pricing Guidelines, the control over risk requirement and the instruction that all contributions should be valued at market price, follow from the fundamental starting point of the ALS that intercompany transactions should be priced according to open market standards. As such, they can be considered mere clarifications of the earlier version of Chapter VIII and therefore will also be relevant in situations governed by tax treaties that were concluded before these changes were implemented.

In respect of the application of the ALS to transactions under a CCA:

- (i) Determining arm's length transfer prices involves a comparability analysis that takes into account the functions performed, risks assumed and assets used by the parties to the transactions at hand. In respect of CCAs especially the assumption of risks associated with the cost shared activities is quite relevant, as that determines whether cash box entities in tax haven jurisdictions can participate.
- (ii) The application of traditional transfer pricing methods is complicated by the specific characteristics of a CCA, most notably the nature of the arrangement as a package deal and the fact that at least part of the benefit for participants is expected to come from their own, individual exploitation of results.
- (iii) If the outcome of a controlled transaction is not in line with the ALS, tax administrations should first seek to make a transfer pricing adjustment. Only when that is not possible, they may consider deviating from the contractual arrangements between parties through a transactional adjustment. However, that CCAs are not frequently found between unrelated parties does not necessarily mean that their outcome conflicts with the ALS and also the lack of comparables most certainly does not by itself justify a transactional adjustment. Instead tax practitioners should first attempt to align the outcome of the arrangement with the ALS by revaluing the contributions under the CCA at hand and adjusting the balancing payments between the participants accordingly.

4. United States

4.1. Introduction

The United States has a longstanding tradition of rulemaking in respect of transfer pricing in general and cost sharing arrangements ("CSAs") in specific.¹²⁶ The IRS and Treasury first proposed regulations including rules for CSAs in the nineteen sixties. As such, it was the only country contributing to the OECD's 1979 *"Report on Transfer Pricing and Multinational Enterprises"* that had issued rules pertaining to cost contribution arrangements. Most likely, at that time the US was the only country in the world to have introduced such rules. Over the years the US regulations governing CSAs evolved significantly. The main driver behind this was the concern of the Treasury and IRS that these arrangements made it too easy for taxpayers to allocate the effective ownership of intangibles to group companies located abroad. The rulemaking that followed was intended to safeguard US tax revenues, but taxpayers did not always agree with the outcome. This led to disputes, litigation and, by consequence, relevant case law, most notably about (i) the compensation payable for making available pre-existing intangibles when entering into a CSA, also referred to as buy-in payments, and (ii) the sharing, or non-sharing, of costs for stock-based compensation of employees. Both issues are still the subject of discussion today, as is illustrated by a recent case brought to court by e-commerce company Amazon.com concerning more than US\$ 1 billion of transfer pricing adjustments over the years 2005 and 2006.¹²⁷ The disagreement with the IRS in that case concerned precisely these two topics.

This Chapter 4 focusses on the both aforementioned bottleneck issues complicating the tax treatment of cost contribution arrangements from a US perspective. I will however first provide some further background to the legislative and regulatory history ultimately resulting in the 2011 Final Cost Sharing Regula-

¹²⁶ In the United States cost contribution arrangements are generally referred to as cost sharing arrangements. There might be marginal differences. For further details see Paragraph 2.2.2.2. For purposes of this chapter both phrases are regarded interchangeable.

¹²⁷ Amazon.com Inc. and subsidiaries v. Commission, 23 March 2017, 148 TC 8.

tions (Paragraph 4.2). Subsequently the rules for calculating a buy-in payment for pre-existing intangibles under a CSA are considered. In that context the prescribed valuation approach under the 2011 Cost Sharing Regulations is discussed as well as its appreciation by the United States Tax Court in the Veritas case and Amazon case (Paragraph 4.3). Furthermore, the validity of the so called all-costs-requirement as the standard for determining whether stock-based compensation expenses should be shared under a CSA is examined. This includes a discussion of the Xilinx case, the Altera case and, again, the Amazon case (Paragraph 4.4). Eventually, conclusions are drawn about today's US tax treatment of cost contribution arrangements and its future direction (Paragraph 4.5).

4.2. Regulatory History

4.2.1. Early Regulatory History (Pre-2005)

Cornerstone of all the United States' transfer pricing rules is Section 482 of the Internal Revenue Code by which Congress authorizes the Secretary of the Treasury to reallocate profit among affiliated taxpayers, if this is required to prevent tax evasion or to clearly reflect the taxpayer's income. The IRS and Treasury proposed regulations under this Section 482 in 1966.¹²⁸ Those proposed regulations were replaced in 1968 by simpler, more general regulations containing a single condensed provision on "*bona fide cost sharing arrangements*".¹²⁹ As already explained in Paragraph 2.2.2 these arrangements were intended as a safe haven to avoid complex valuation issues in respect of intangibles by an upfront agreement on collective ownership. It is noteworthy that already at this early time Surrey, the Assistant Secretary of the Treasury for Tax Policy in charge of the drafting of the regulations, recognized that the valuation of pre-existing intangibles was a complicating aspect that would require more attention in the future:

*"One of the principal problems remaining is the requirement that the use of previously developed intangibles be valued. We have discussed various alternatives to this extremely difficult task with industry representatives and members of the legal and accounting professions. We hope that together we can develop a satisfactory alternative which will eliminate this valuation problem."*¹³⁰

128 Treasury and IRS, Proposed Transfer Pricing Regulations, 1966, 31 Fed Reg 10394 (1966).

129 Treasury and IRS, Final Transfer Pricing Regulations, 1968, 33 Fed Reg 5854 (1968).

130 Surrey, Journal of Taxation 1968, page 75 – 79.

The later developments discussed in Paragraph 4.3 will evidence how the issue has remained at the center of debate ever since. For now it is important to note that through the early transfer pricing regulations the Secretary authorized the Commissioner to allocate income and deductions among related parties, if that was necessary to produce arm's length outcomes. At this stage the regulations provided methods for setting intercompany prices on a transaction basis. They did not take profitability into consideration directly and did not include any profit split methods.

In the nineteen eighties it was felt that more detailed guidance was required, specifically in respect of transactions involving high value intangibles such as those structured as license and cost sharing agreements. Congress addressed this issue, when it added the so called commensurate-with-income standard as a second sentence to Section 482 as part of the Tax Reform Act of 1986. This enunciated that the income related to any transaction involving intangible property should be commensurate with the income attributable to the intangible.¹³¹ Quite controversially the commensurate-with-income standard required a periodic adjustment of the compensation received by a licensor or transferor of intangible property, which in case of licensing arrangements resulted in a so called super royalty. Although the commensurate-with-income standard and especially its potential sanctioning of the use of hindsight has been challenged by both taxpayers and foreign tax administrations, the IRS has to date continued to defend that the standard is in line with the ALS.

Whereas Congress clearly had a concern about the compensation received by US multinationals for making available or transferring their intangible property to foreign affiliates, the Conference Report accompanying the Tax Reform Act of 1986 stated explicitly that Congress did not intend to preclude the use of bona fide R&D cost sharing agreements:

"In revising Section 482, the conferees do not intend to preclude the use of certain bona fide cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflects the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on successful as well as unsuccessful products within an appropriate product area, and the cost of

131 HR, Conference Report to accompany HR 3838, No. 99-841 (1986).

research and development at all relevant developmental stages would be included.”

Congress in other words continued to allow the use of cost sharing arrangements as an opportunity to agree collective ownership before the intangible property was developed and thus avoid a taxable transfer of such property as well as the accompanying valuation issues later. At the same time however, the Conference Committee deciding on the 1986 tax reform also suggested that the IRS conduct a comprehensive study reviewing the existing transfer pricing rules and regulations in general. The IRS followed up on this and in 1988 published a document entitled “*A Study of Intercompany Pricing under Section 482 of the Code*”.¹³² This document is also referred to as “*the White Paper*”. It included two separate chapters on cost sharing, one on the history of CSAs and one on their use after the Tax Reform Act of 1986. The first chapter started off by stating that “*CSAs have long existed at arm’s length conditions between unrelated parties*”. However, as the IRS and Treasury admitted to have little experience with both related and unrelated CSAs, they welcomed receiving information from taxpayers regarding their contractual arrangements and experience with cost sharing.

Based on the information already available, the White Paper went on to analyze the status of the regulatory framework for cost sharing at the time. This resulted in a recommendation to introduce a more narrow definition of a bona fide CSA under which taxpayers would be required to include standard provisions in the underlying agreements. It would become mandatory to assign participants exclusive geographic rights in the developed intangibles. Furthermore, arrangements for developing marketing intangibles as well as manufacturing intangibles were to be excluded from qualifying. Eventually much more relaxed regulations were proposed in 1992¹³³ and then finalized in 1995¹³⁴. In fact the 1995 Final Regulations provided the first set of final regulations dealing specifically with cost sharing agreements. The preamble explained that they allowed for more flexibility, because comments to the White Paper had indicated “*that there was a great deal of variety in the terms of bona fide cost sharing arrangements and that if the White Paper’s suggestions were incorporated in regulations, the regulations would unduly restrict the availability of cost sharing*”. In the 1995 Final Regulations the Treasury and IRS therefore relied only on anti-abuse tests

132 Treasury and IRS, “*A Study of Intercompany Pricing under Section 482 of the Code*”, 18 October 1988, Notice 88-123 (1988-2 C.B. 458) (“*White Paper*”).

133 Treasury and IRS, 1992 Proposed Cost Sharing Regulations, 57 Fed Reg 3571 (1992).

134 Treasury and IRS, 1995 Final Cost Sharing Regulations, 60 Fed Reg 65557 (1995).

rather than that they prescribed standard contractual provisions or limited the type of intangibles that could be developed under the agreements. Another key element of these regulations was the requirement of a compensation payment for the contribution of pre-existing intangibles, referred to in these regulations as a “*buy-in payment*”.¹³⁵ Such payments were already considered to be required under the ALS and applied by many taxpayers in practice. There had however not been any explicit reference made to them in earlier regulations.

Over the following years the 1995 Final Regulations were revised and updated on several occasions.¹³⁶ Most notably explicit wording was added in 2003 on the requirement to include the expenses for stock-based compensation in the shared costs.¹³⁷ This later became the subject of litigation in the Xilinx case, the Altera case and the Amazon case. The 2003 changes to the Cost Sharing Regulation and the related case law are further discussed in Paragraph 4.4.3.

4.2.2. Recent Regulatory History (2005 Onwards)

4.2.2.1. The 2005 Proposed Cost Sharing Regulations

Before the 1995 Cost Sharing Regulations, the so called buy-in payment for the use of pre-existing intangibles was commonly structured as a declining royalty paid to the contributor based on the limited economic lifetime of such intangibles. This approach had also been accepted by the United States Tax Court.¹³⁸ The IRS and Treasury however were not always satisfied with the outcome. They had grown a justifiable concern that CSAs were being used to transfer intangibles developed in the US to affiliates in low tax jurisdiction at prices below their fair market value. Eventually the acting Assistant Secretary of the Treasury for Tax Policy, Pamela F. Olson, in June 2002 announced a full revision of the Cost Sharing Regulations. She stated that such revision was required to avoid that CSAs were used to “*facilitate a disguised transfer of intangible assets outside the United States in a manner inconsistent with the arm’s length standard*”.¹³⁹ The work was to focus specifically on the effectiveness of rules intended to apply the ALS to taxpayers that contributed pre-existing intangibles, which often were considered to be the most valuable assets of the company. Three years later, in 2005, the revision efforts resulted in new regulations being proposed.¹⁴⁰

135 Idem, Paragraph 1.482-7(g)(1).

136 61 Fed Reg 33656 (1996); 66 Fed Reg 295 (2001); 68 Fed Reg 51177 (2003); 69 Fed Reg 13473 (2004).

137 Treasury and IRS, Update of the 1995 Final Cost Sharing Regulations, 68 Fed Reg 51177 (2003).

138 See the 1994 court case of Seagate v. Commissioner, which is discussed in detail in Paragraph 6.3.2.

139 Testimony of Pamela F. Olson, Department of the Treasury acting assistant secretary for tax policy, before the House Ways and Means Committee on Corporate Inversion Transactions, 6 June 2002.

140 Treasury and IRS, 2005 Proposed Cost Sharing Regulations, 70 Fed Reg 51116 (2005).

Although the IRS and Treasury had claimed in the 1988 White Paper that cost sharing was common among third parties, they acknowledged in the preamble to the 2005 Proposed Regulations that in reality the existing arrangements between third parties are generally not analogous to CSAs between affiliates. Third party agreements would typically involve “*a materially different division of costs, risks and benefits than in CSAs under the regulations*”.¹⁴¹ The 2005 Proposed Regulations went on to reverse some of the flexibility offered by the 1992 Proposed Regulations and 1995 Final Regulations. For example the recommendation from the White Paper to require CSAs to assign participants exclusive geographical rights in the developed intangibles was reconsidered and adopted. At the same time detailed formal rules were introduced consisting of specified contractual, documentation, accounting and reporting requirements. Furthermore, as the Assistant Secretary of the Treasury for Tax Policy had predicted, the guidance in respect of the contribution of pre-existing intangibles became the core of the Proposed Cost Sharing Regulations. These were referred to as “*external contributions*” to be compensated in a “*preliminary or contemporaneous transaction*”.¹⁴² The 2005 Regulations assumed that the arm’s length character of all transactions under a CSA was best evaluated on an aggregated basis. To facilitate this, the so called investor model was introduced. As explained in the preamble of the Proposed Regulations this model assumes that the aggregate contributions made by a participant constitute an investment that should earn an appropriate expected return taking into account the risks borne by participants during the development and exploitation of the cost shared intangibles. In explanation of their choice for the investor model the Treasury and IRS referred to a quote from Congress in the context of the Tax Reform Act of 1986:

*“...it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. In addition, to the extent, if any, that one party is actually contributing funds towards research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.”*¹⁴³

¹⁴¹ See also Paragraph 2.2.1.

¹⁴² 2005 Proposed Cost Sharing Regulations, Paragraph 1.482-7(b)(3).

¹⁴³ HR, Conference Report to accompany HR 3838, No. 99-841 (1986), at II-638.

The rules presented in the 2005 Proposed Regulations on the valuation of preliminary and contemporaneous transactions were interpreted by some tax practitioners to disallow the use of a higher discount rate for determining the net present value of returns of participants assuming more financial risk. That would have required cash box participants to pay higher buy-in payments and thus it would have significantly limited their entitlement to residual profits.

4.2.2.2. *The 2008 Temporary Cost Sharing Regulations*

The 2005 Proposed Regulations were already quite comprehensive and extremely detailed. Including the preamble they consisted of 184 pages. After they were published the IRS and Treasury received extensive comments on many of the issues that they addressed in the Proposed Regulations. Not surprisingly many of the commentators criticized the restrictions in respect of the qualifying types of agreements and the presumed inflexibility of the investor model. To some extent they were accommodated when the 2005 Proposed Regulations were replaced by the 2008 Temporary Regulations.¹⁴⁴ By now the document had grown to 195 pages. As an alternative for the assignment of geographical rights in developed intangibles a division of interests based on the “*field of use*” was introduced. Other means of dividing interests were also allowed, provided they met specific conditions in respect of their practical applicability. However, the suggestion by some commentators to apply the tax treatment of CSAs to any arrangement between affiliates aimed at creating intangibles was a bridge too far. As the IRS and Treasury explained in the preamble to the 2008 Temporary Regulations:

“Because the cost sharing rules are designed to provide guidance for specific types of transactions and arrangements, the Treasury Department and the IRS continue to believe that the new rules set forth for CSAs should apply only to the transactions intended. From the standpoint of the purpose of the cost sharing rules and their administrability, it is important that the rules be applicable only to the defined scope of intangible development arrangements and apply no more broadly or narrowly than intended.”

The 2008 Temporary Cost Sharing Regulations also introduced a whole new set of terminology in respect of compensation payments for the contribution of pre-existing intangibles (discussed in Paragraph 4.3.3.1). Furthermore, the preamble was used to clarify the position on risk assumption and the use of

¹⁴⁴ Treasury and IRS, 2008 Temporary Cost Sharing Regulations, 74 FR 9570 (2009).

discount rates. The interpretation as if the Proposed Regulations prescribed the use of a single discount rate for all calculations under a cost sharing analysis was rejected. Instead the 2008 Temporary Regulations explicitly allowed for discount rates to vary when determining the net present value of the expected returns of individual participants. By consequence, a participant assuming more financial risk can use a higher discount rate than a participant assuming less financial risk and would therefore pay a lower buy-in payment. It was also explicitly mentioned that discount rates could vary when comparing the outcome of CSAs to that under realistic alternatives. For example, a participant under a CSA generally assumes more risk than a licensee under a license arrangement and therefore a higher discount rate should be used for calculating the net present value of the anticipated benefits of the CSA scenario, when comparing both options.

4.2.2.3. *The 2011 Final Cost Sharing Regulations*

The 2008 Temporary Regulations were replaced by the issuance of the Final Regulations on 16 December 2011.¹⁴⁵ By now the issued document covered 202 pages. The Final Regulations follow the main principles from the 2008 Temporary Regulations. This includes the less prominent role of the investor model than under the 2005 Proposed Regulations. The preamble to the latter included an extensive explanation of its meaning and purpose as “*a fundamental concept*” of cost sharing, but this language was not repeated in later regulations. Nevertheless, the investor model is still the theoretical basis for the specified methods for pricing platform contribution transactions. The implications of this are discussed in detail in Paragraph 4.3.3 below. The 2011 Final Regulations also adopted the effective date and transition rules of the 2008 Temporary Regulations letting them apply to all CSAs entered into from 5 January 2009 onwards. Pre-existing arrangements are required to have been compliant with the 1995 Regulations, while the activities of the participants needed to substantially comply with the rules of the Final Regulations and the underlying written agreement had to be updated accordingly by 6 July 2009 at the latest.¹⁴⁶

¹⁴⁵ Treasury and IRS, 2011 Final Cost Sharing Regulations, 76 Fed Reg 80082 (2011).

¹⁴⁶ Idem, Paragraph 1.482-7(m)(1).

4.3. Buy-in Payments

4.3.1. Introduction

As already explained above, the Treasury and IRS have for some time been concerned that CSAs are used to allocate intangibles to group companies abroad without the US taxpayer receiving sufficient compensation. This has caused quite some discussions about the consideration that participants should receive for the contribution of pre-existing intangibles under a CSA. The thinking around this topic evolved over the years and drastically changed direction with the publication of the 2005 Proposed Regulations. This Paragraph 4.3 first illustrates the pre-2005 practice in respect of buy-in payment by looking at the 1994 Seagate case and then examines the concept of “*platform contribution transactions*” under later regulations. Subsequently, it discusses how the valuation approach advocated by the IRS has been rejected by the US Tax Court in the Veritas and Amazon case.

4.3.2. Buy-in Royalties under Earlier Cost Sharing Regulations

After the addition of the commensurate-with-income standard to Section 482 in 1986 compensation payments for the contribution of pre-existing intangibles were generally structured as declining royalty payments. These royalties would ramp down over the limited economic lifetime of the intangibles developed under a CSA. In 1994 this so called ramp down approach was accepted by the United States Tax Court in *Seagate Technology v. Commissioner*.¹⁴⁷ This would later be considered “*a foundational cost sharing case*”.¹⁴⁸

Seagate Technology Inc. was, and today still is, a major manufacturer of computer hard disk drives. It was established in 1979 and is based in Scotts Valley California (United States). After a flying start the company faced serious economic challenges in the early eighties. Market prices fell, while competition intensified. In reaction Seagate sought to reduce costs by using an offshore manufacturing and distribution subsidiary in Singapore. That could have been inspired by opportunities of labor arbitration or the 10-year tax holiday offered to the company in Singapore. However that may be, Seagate Singapore was established in July 1982 to manufacture hard disk drives and hard drive components. It sold these products back into the US via Seagate Scotts Valley as well as to third parties directly. The company was quite successful. Starting with

¹⁴⁷ *Seagate Technology v. Commissioner*, 8 February 1994, 102 TC 149.

¹⁴⁸ Heriford, Keates, Lamoureux and Wright, *International Transfer Pricing Journal* 2013/4.

approximately 50 employees, it grew into the second largest employer in Singapore, employing more than 8,000 people by 1987.

Within the group most R&D activities were performed by Seagate Scotts Valley. In the spring of 1985 Seagate Scotts Valley and Seagate Singapore entered into a cost sharing agreement. R&D costs were shared equally, while both participants were appointed the right to use, within limited geographical areas, the intangible property developed under this agreement. Seagate Scott Valley's exclusive territory was the Americas, while Seagate Singapore's exclusive territory consisted of South-East Asia, India and China. The CSA was supplemented by a license agreement for the use of Seagate Scotts Valley's pre-cost sharing disc drive technology and know-how as well as the exploitation of products obtained through the use of that technology and know-how. The royalty payable for the license was set at 1 percent of sales.

Unfortunately for Seagate the IRS challenged the group's transfer pricing set-up. The subject of discussion included the intercompany sales price of hard drives and hard drive components manufactured in Singapore and sold to Seagate Scotts Valley, the split of costs under the CSA, the size of the royalty payable under the license agreement as well as several other intercompany transactions. Over the years 1983 to 1987 the IRS reallocated more than US\$ 285 million of profit from Singapore to the US. Seagate petitioned against the deficiencies at the United States Tax Court, where both parties brought in several experts to substantiate their positions. At the end of the day the Tax Court was convinced that Seagate Scotts Valley's management expected Seagate Singapore to benefit most from the R&D conducted in the US after the manufacturing capability was transferred to Singapore. As neither party presented third party cost sharing agreements that could serve as guidance for its decision, the Tax Court used its best judgment to conclude that 75 percent of the R&D expenses should be allocated to Seagate Singapore and 25 percent to Seagate Scotts Valley. Furthermore, the Tax Court concluded that third party agreements presented as comparables for the license agreement did not concern the same or similar intangibles and contained different conditions. The Court however did accept the conclusion by one of Seagate's experts that royalty rates for disk drive technology generally ranged from 1 to 5 percent. At the same time it established that Seagate Scott Valley's management anticipated Seagate Singapore to become the sole manufacturer of certain types of disk drive models that were at the early stages of their economic lifecycle. As such the Court did not approve of Seagate setting the royalty at the low-end of the range and decided that it had to be increased from 1 to 3 percent.

Although the adjustment of the royalty rate was not in favor of the taxpayer, the important aspect to note is that the Tax Court did accept Seagate's principle choice to structure the compensation for the pre-existing intangibles as a royalty payment based on the economic lifetime of the intangibles. As such, the ruling in the Seagate case confirmed the standard operating practice under the commensurate-with-income standard. The Treasury and IRS however remained dissatisfied with that approach, which ultimately resulted in stricter guidance and more specified valuation methods being included in the Cost Sharing Regulations as from 2005 (see Paragraph 4.2.2).

4.3.3. Platform Contributions under Recent Cost Sharing Regulations

4.3.3.1. Terminology

The US Cost Sharing Regulations have always used an extensive set of specialized terms. New relevant terminology categorizing the different types of contributions under CSAs was introduced in the 2008 Temporary Regulations and continued in the 2011 Final Regulations. Most notably these Regulations replaced the concept of external contributions used in the 2005 Proposed Regulations¹⁴⁹ by that of "*platform contributions*", which are made available and should be compensated for in "*platform contribution transactions*" or "*PCTs*". A platform contribution is defined as:

*"...any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles."*¹⁵⁰

¹⁴⁹ Paragraph 4.482-7(b)(3)(iii) of the 2005 Proposed Cost Sharing Regulations explained that an external contribution was a contribution consisting of "*the rights [...] in any resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles and that [the contributing participant] has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA.*"

¹⁵⁰ 2011 Final Cost Sharing Regulations, Paragraph 4.482-7(c)(1).

Under this definition platform contributions are not limited to the stricter definition of intangibles as provided elsewhere in the Internal Revenue Code.¹⁵¹ Instead various other resources also qualify as a platform contribution, such as making available a workforce in place (e.g. a uniquely skilled and experienced research team), goodwill or going-concern value. This is a crucial consideration, because it expands the buy-in payment to the sale of a business opportunity rather than “only” a transfer or license of narrowly defined pre-existing intangibles. As such according to the Treasury and IRS the buy-in consideration should not just reflect the fair market value of the pre-existing intangibles included in the PCT, but it should also be increased depending on the further profits expected from new intangibles developed under the CSA. Such PCT can take the form of a lump sum payment as well as a multiyear royalty.¹⁵²

Platform contributions have to be distinguished from “cost contributions”. The latter concerns payments to fund ongoing intangible development costs under the CSA.¹⁵³ Cost contributions can consist of internal costs related to the ongoing performance of cost shared activities or third party costs, such as costs for materials or costs for services provided by third parties. Cost contributions are leveled out in accordance with each participant’s reasonably anticipated benefits from the cost shared intangibles through so called Cost Sharing Transactions or “CSTs”. They are generally settled at cost, i.e. without a profit mark-up.

In addition to platform contributions and cost contributions a participant can also make “operating contributions” and “operating cost contributions”. operating contributions are contributions of pre-existing resources, capabilities or rights related to the exploitation of cost shared intangibles. As the preamble to the 2011 Final Regulations puts it:

“The concepts of platform and operating contributions are intended to encompass any existing inputs that are reasonable anticipated to facilitate developing or exploiting cost share intangibles at any time, including

151 Section 936(h)(3)(B) of the Internal Revenue Code defines intangibles as any:

- (i) patent, invention, formula, process, design, pattern, or know-how;
- (ii) copyright, literary, musical, or artistic composition;
- (iii) trademark, trade name, or brand name;
- (iv) franchise, license, or contract;
- (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- (vi) any similar item, which has substantial value independent of the services of any individual.

This definition of intangibles is also copied in Paragraph 1.482-4(b) of the Section 482 Regulations.

152 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(h)(2).

153 Idem, Paragraph 4.482-7(d)(4).

resources, capabilities, or rights, such as expertise in decision-making concerning research and product development, manufacturing or marketing intangibles or services, and management oversight and direction.”

Operating cost contributions on the other hand are contributions to cover costs related to the development of resources, capabilities, or rights related to the exploitation of cost shared intangibles.

4.3.3.2. Pricing Methods

Covering over 50 pages the guidance on the pricing of platform contribution transactions is a major part of the 2011 Final Cost Sharing Regulations. Paragraph 1.482-7(g)(1) includes five specified methods that might be used for that purpose:

- (i) the comparable uncontrolled transaction (“CUT”) method and the comparable uncontrolled service price (“CUSP”) method;
- (ii) the income method;
- (iii) the acquisition price method;
- (iv) the market capitalization method; and
- (v) the residual profit split method.

Taxpayers are also allowed to use an unspecified method, but only to the extent it produces a more reliable result.¹⁵⁴ Such an unspecified method should at least provide information on the prices or profits that the participant could have realized by choosing a realistic alternative to cost sharing.

Ad (i): The CUT Method and CUSP Method

In a cost sharing context the CUT method is used to evaluate the amount charged for the transfer of intangible property, while the CUSP method is used to evaluate the amount charged for a services transaction. Both methods determine the appropriate arm’s length amount by reference to comparable uncontrolled transactions. This requires reference to transactions involving comparable intangible property or services, under comparable conditions and in

¹⁵⁴ Idem, Paragraph 1.482-7(g)(8).

comparable circumstances. The Treasury and IRS regard the comparability and reliability to depend specifically on similarity in the way risks have been split up between parties.

Ad (ii): The Income Method

The income method appears to be the preferred method of the Treasury and IRS. It calculates the appropriate arm's length PCT payment as the difference between the present value of a participant's expected results under the CSA and the present value of that participant's expected results under the so called best realistic alternative to cost sharing.¹⁵⁵ For a PCT payer the best realistic alternative to cost sharing is assumed to be the licensing of the new to be developed intangibles from an uncontrolled licensor. For a PCT payee the best realistic alternative is the exact opposite, namely to perform the cost shared activities itself and then license out the intangibles to an uncontrolled licensee. As under the best realistic alternative to cost sharing the licensor bears all the risk of the development of the intangibles and the licensee does not share in such risk, the discount rate used to calculate the present value of their expected results in that scenario has to be adjusted accordingly.

The income method can be illustrated by the following stylized example inspired by the facts and circumstances of the Seagate case:

A US resident company manufactures computer hard disks. In anticipation of market developments the company is looking to develop a new generation hard disks based on a pre-existing model. For that purpose it concludes a cost sharing agreement with its recently established, fully owned Singapore subsidiary. Under this agreement the US parent has the right to sell the new hard disks in the US, while the Singapore subsidiary has the right to sell them in South-East Asia, India and China. The pre-existing know-how and technology related to manufacturing the new hard disks and the availability of an experienced R&D team employed by the US parent are expected to contribute significantly to the development of the new hard disks and therefore constitute platform contributions for which the Singapore subsidiary should pay an arm's length compensation in a PCT. For the purpose of the example it is assumed that the reasonably anticipated revenues of the Singapore subsidiary from future sales of the new hard disks are as shown in the table below. These are reduced by the operating costs of the Singapore subsidiary and the cost contributions it pays to its US affiliate under

¹⁵⁵ Idem, Paragraph 1.482-7(g)(4)(i)(A).

the CSA. This then leaves the Singapore entity's operating income (A). After year 10 there are no more sales expected. The company has an ambition to realize an internal rate of return on risk bearing R&D activities of 16% and therefore the operating income is discounted using a similar discount rate. As shown below, this implies a net present value of the Singapore entity's overall forecasted results under the CSA of US\$ 1,600M.

Amounts in US\$ * 1 million

Year	Sales of new hard disks	Operating costs	Cost contributions	Singapore subsidiary's operating income (A)	Discount factor using a discount rate of 16% (B)	Net present value of the Singapore subsidiary's operating income at the outset of the CSA (A x B)
1	0	0	60	-60	0.8621	-52
2	200	40	80	80	0.7432	59
3	500	80	100	320	0.6407	205
4	800	120	90	590	0.5523	326
5	940	160	80	700	0.4761	333
6	1000	160	60	780	0.4104	320
7	800	110	40	650	0.3538	230
8	540	80	40	420	0.3050	128
9	300	80	30	190	0.2630	50
10	80	50	30	0	0.2267	0
Total Net Present Value of Cost Sharing Scenario						1,600

It is further assumed for the purpose of the example that it can be evidenced that in an uncontrolled transaction a licensee would, instead of the cost contributions, pay a royalty equal to 30% of sales for the use of the technology and know-how to manufacture comparable hard drives.¹⁵⁶ This would leave the Singapore entity with a lower operating income (A). However, as an uncontrolled licensee it would not bear any risks related to the development of the new versions and it would therefore be satisfied with an internal rate of return of just 14%. At this discount rate the net present value of the results in the best realistic alternative scenario is US\$ 1,350M.

¹⁵⁶ As an alternative to the CUT method the 2011 Final Cost Sharing Regulations also allow for the so called comparable profits method ("CPM") for determining the royalty that an uncontrolled company would have paid for such rights. Under the CPM the royalty is based on the excess of the PCT payer's expected operating income above a fixed routine profit.

Amounts in US\$ * 1 million

Year	Sales of new hard disks	Operating cost	License fee	Uncontrolled licensee's operating income (A)	Discount factor using a discount rate of 14% (B)	Net present value of the uncontrolled licensee's operating income at the outset of the license arrangement (A x B)
1	0	0	0	0	0.8772	0
2	200	40	60	100	0.7695	77
3	500	80	150	270	0.6750	182
4	800	120	240	440	0.5921	261
5	940	160	282	498	0.5194	259
6	1000	160	300	540	0.4556	246
7	800	110	240	450	0.3996	180
8	540	80	162	298	0.3506	104
9	300	80	90	130	0.3075	40
10	80	50	24	6	0.2697	2
Total Net Present Value of Licensing Alternative						1,350

The income method specified in the Cost Sharing regulations is based on the principle that the risk adjusted return of a PCT payer in a CSA scenario should not be different from its risk adjusted return in the best realistic alternative scenario. This implies that any excess profit represents the value of the platform contributions and should therefore be paid over to the participant making those platform contributions. In this case that means that the Singapore subsidiary would have to pay an amount of US\$ 250 million to the US parent, being the difference between US\$ 1,600 million and US\$ 1,350 million.

Ad (iii): The Acquisition Price Method

The acquisition price method is specifically appropriate, if a newly acquired subsidiary enters into the group's CSA shortly after its acquisition. This method uses the purchase price paid in an uncontrolled transaction for shares in a subsidiary or all the assets of a business as reference for determining the arm's length PCT payment. The PCT payment should equal the so called adjusted acquisition price, consisting of the purchase price plus the liabilities of the target on the date of acquisition minus the value of the target's assets that are not part of its platform contributions. The acquisition price method can be very suitable when a special purpose vehicle holding only intangible property is acquired and a CSA is set up to further develop these intangibles. It is regarded to become less reliable however, if a longer period of time passes between the acquisition and the moment of entering into the CSA. Furthermore, the adjusted acquisition price is probably more difficult to calculate accurately, if the target owns significant

difficult to value (intangible) assets that are not contributed to the CSA. It is not difficult to imagine that this can specifically cause complications, if the target has pre-acquisition operational activities of its own that are not covered by the CSA, while the purchase price included a compensation for the going concern value and goodwill in relation to those activities. In that case, it would after all be necessary to accurately determine what part of the purchase price can be attributed to such going concern value and goodwill and exclude that value from the PCT payment, as these assets are not contributed under the CSA.

Ad (iv): The Market Capitalization Method

The market capitalization method is suggested for evaluating PCTs, if the shares in the contributing entity are regularly traded on a public stock exchange. An arm's length PCT should equal the so called adjusted average market capitalization. This is made up of the average of the daily market capitalizations in the last 60 days preceding the PCT plus the value of the PCT payee's liabilities on the date of the PCT minus the value of the payee's assets that are not part of its platform contribution. Just like with the acquisition price method, it would appear to be difficult determining the PCT on the basis of the market capitalization method, if the PCT payee has significant difficult to value (intangible) assets and operational activities that are not covered by the CSA. Most likely the market capitalization method is only useful in very specific situations, for example if a highly specialized publicly traded US company starts to expand internationally.

Ad (v): The Residual Profit Split Method

Paragraph 1.482-7(g)(7) includes a version of the so called residual profit split method to value platform contributions and operating contributions. This method is allowed only, if two or more participants to a CSA make platform contributions or operating contributions. It prescribes that the PCTs allocate the net present value of the residual divisional profits on the basis of the relative value of these platform and operating contributions. For these purposes this relative value can be measured using either external market benchmarks that reflect the fair market value of the non-routine contributions or the capitalized costs of developing the platform or operating contributions, appropriately grown or discounted so they provide a comparable dollar comparison on the date of the PCT payment.¹⁵⁷ If for example the relative value of the platform contributions by participants A and B are 50 and 100 respectively, then the rela-

¹⁵⁷ 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(g)(7)(2).

tive size of the net present value of anticipated residual profit of both participants should be similar, e.g. 500 and 1,000. If however the net present value of participant A's anticipated residual profit is 300 and that of participant B is 1,200, then B should make a PCT payment of 200 to A to restore the balance. Such a stylized numeric example may give the unjustified impression that application of the residual profit split method is simple. In fact however, applying the profit split method can in practice be quite problematic. First of all, it requires an appropriate allocation of profit to routine cost sharing contributions in order to determine the residual divisional profits. Secondly, it can be up for debate whether the capitalized development costs are a suitable basis for determining the relative value of non-routine contributions. It could be argued that non-routine contributions with different risk profiles require different returns and, therefore, a different calculation of PCT payments.

4.3.3.3. Periodic Adjustments

4.3.3.3.1. The Actually Experienced Return Ratio

The Cost Sharing Regulations allow the Commissioner to make periodic adjustments to PCT payments, if the returns of individual participants are not in line with the ALS. Before any adjustment is made all relevant facts and circumstances will have to be considered. Extraordinary events that are beyond the control of the cost sharing participants and could not reasonably have been anticipated can offer a legitimate explanation for unexpected outcomes. Such events are likely to have occurred, if the return ratios of all participants show a similar deviation from forecasts. However, there can also be unforeseen conditions impacting the results of only one or a limited number of individual participants. Those may be more difficult to evidence. The Regulations also contain a safe haven rule, under which no adjustments are made if a participant's so called actually experienced return ratio stays within a predefined range. To qualify for this rule the Cost Sharing Regulations require a participant's overall return from cost shared activities to not be less than 66% or more than 150% of its overall contributions under the CSA. If the cost sharing participant has not complied with the documentation requirements included in the regulations, the range is narrowed to 80% at the low end and 125% at the top end. The safe haven rule is further nuanced by the assumption that adjustments because of a return ratio below the lower limit of the range will not be made in the first five years subsequent to the first substantial exploitation of the cost shared intangibles. Furthermore, if the return ratio has fallen within the range for the first ten years subsequent to the first substantial exploitation of the cost shared intangibles,

the regulations also deem adjustments not to occur in later years. Finally, there would normally not be any adjustments made, if the same PCT payment is also furnished to an unrelated third party under substantially the same circumstances or if the PCT is covered by an advanced pricing agreement.

4.3.3.3.2. *Use of Hindsight*

There are principle arguments to be made against periodic adjustments as set out in the regulations, because they appear to provide the IRS with the benefit of hindsight. A PCT payer might argue that the IRS is retroactively denying a rightful return for a bona fide assumption of risk. The use of hindsight in transfer pricing is controversial. It is something the OECD's Transfer Pricing Guidelines traditionally oppose¹⁵⁸, although they do not include a clear definition of the phenomenon. Furthermore, the OECD has recently sanctioned the use under certain conditions of so called ex post results to determine whether a retroactive adjustment to the pricing of hard to value intangibles is justified (see Paragraph 5.5.3.2.4). Meanwhile the Treasury and IRS argue that the wording on periodic adjustments in the cost sharing regulations is simply a further specification of the commensurate-with-income standard. In the preamble to the 2008 Temporary Cost Sharing Regulations they again refer to the legislative history of the Tax Reform Act of 1986, pointing out that Congress intended for taxpayers to be able to use CSAs only *"if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each"*. In light of the information asymmetry between taxpayers and tax authorities, they apparently consider periodic adjustments both necessary and reasonable.

4.3.3.4. *The 2007 Coordinated Issue Paper*

As long as the 2005 Proposed Regulations were not finalized, the 1995 Final Regulations stayed in force. Nevertheless the IRS published a Coordinated Issue Paper ("CIP") in September 2007 that basically instructed its field agents to already start using the income method as set out in the 2005 Proposed Regulations for valuing pre-existing intangibles and calculating buy-in payments.¹⁵⁹ The CIP recognized two typical buy-in scenarios. The *"initial buy-in scenario"* concerned a new CSA between a US participant with an existing R&D capability and a foreign affiliate. For that scenario the CIP considers the income method, also referred to as the foregone profits method, the most reliable method for

¹⁵⁸ OECD 1995 Transfer Pricing Guidelines, Paragraph 3.74.

¹⁵⁹ Treasury and IRS, Coordinated Issue Paper – Sec. 482 CSA Buy-in Adjustments, 27 September 2007, LMSB-04-0907-62.

measuring an initial buy-in. The “*subsequent acquisition buy-in scenario*” involved the acquisition of intangibles by the cost sharing participants from a third party in an asset or stock acquisition. Not surprisingly, in this scenario the value of intangibles is determined by the acquisition price method.

The CIP challenged the appropriateness of the CUT method for determining a buy-in payment. It basically claimed that uncontrolled transactions referenced by taxpayers to apply the CUT method would generally lack similar profit potential or would not feature similar contractual terms and economic conditions. Furthermore, the CIP disapproved of an alternative version of the residual profit split method (“*RPSM*”) to compensate for pre-existing intangibles. This method involved splitting the aggregate residual profit from cost shared activities, i.e. the total profit after routine contributions are appropriately compensated, among participants based on their respective share in capitalized and amortized past and current development costs. I understand this to work as follows: Assume a US parent has incurred US\$ 1.5 million for the development of a platform intangible. These costs are capitalized and amortized over a 5 year period. It subsequently enters into a CSA with a foreign subsidiary to on-develop the platform intangible into new commercially exploitable intangibles. The ongoing development costs are approximately US\$ 500k per annum, which under the CSA are shared between the US parent, US\$ 100k, and the foreign subsidiary, US\$ 400k, based on their anticipated benefit from exploitation of the cost shared results in their own territories. Under these circumstances the alternative RPSM would during the first five years take into account the amortization of the pre-existing development costs and allocate 40% of residual profit to the US parent; $(US\$ 300k + US\$ 100) / US\$ 800k$. In later years it would allocate only 20% of the residual profits to the US parent; $US\$ 100 / US\$ 500$. The IRS contested that by doing so, it would be insufficiently recognized that the pre-existing development activities could have presented a very different risk profile. The IRS was concerned that the US parent would be under compensated for taking on all the risk during the most uncertain initial phase of a development project. It also felt that there could be a potential distortion of results by difficult to verify assumptions regarding useful life of the platform intangibles. Having rejected these alternatives, the CIP came back to the income method as it would offer the more appropriate solution:

“This CIP concludes that in the typical initial buy-in scenario an unspecified method known as the income or foregone profits method will generally constitute the most reliable method for measuring an initial buy-in (in the aggregate with the tandem license of make-sell rights). This method deter-

mines the value of the buy-in intangible (along with the licensed make-sell rights) as the present discounted value of the stream of projected operating profits of the CFC (or affiliated CFCs), after project under the CSA.”

It recognized that there had been disputed about how to account for the value of an experienced US research team being made available and it argued that, even if such workforce in place would not be considered an intangible asset, it would at least entail a certain “*synergy value*” with an increasing effect on the buy-in payment. Taxpayers were allowed the freedom to structure the buy-in as a lump-sum or a periodic royalty payment and in applying the income method the taxpayer’s own financial projects were to be accepted as a starting point. However, it was also acknowledged that in some cases IRS personnel would need to develop own projections. The instruction in the CIP were to be used as a blueprint in respect of all outstanding CSA valuation issues without taking into account specific fact and circumstances of an individual case at hand. It was also disregarded that the audited CSAs were still governed by the 1995 Cost Sharing Regulations, which did not specify the income method. In practically all instances the IRS now required buy-in payments to be calculated using the income method. This rigorous approach led to many conflicts with taxpayers. It was unavoidable that the matter eventually ended up in court and so it did. That resulted in the Veritas case¹⁶⁰ and Amazon case¹⁶¹, both of which are further discussed below.

4.3.4. The Veritas Case

4.3.4.1. Facts of the Case

Veritas Software Corporation (Veritas) manufactures and sells so called advanced storage management software products. These products facilitate making a back-up of systems without user interruption and the recovery of data in case of disk or system failure. They protect against data loss and file corruption and, by doing so, provide performance improvement and reliability enhancement, which is critical for many commercial applications. Veritas historically had only limited presence outside of the US. Nevertheless, at the end of the nineteen nineties it recognized that geographic expansion presented an opportunity to increase sales and profits. In 1999 it set up a legal structure with an Irish subsidiary, Veritas Software International Ltd. That company was

¹⁶⁰ Veritas Software Corporation and subsidiaries v. Commissioner, 10 December 2009, 133 TC 14.

¹⁶¹ Amazon.com Inc. and subsidiaries v. Commission, 23 March 2017, 148 TC 8.

held via a Bermuda based intermediate holding company. Veritas Ireland was assigned all the existing sales agreements with European based sales subsidiaries. Furthermore, Veritas US and Veritas Ireland entered into a CSA and a license agreement. Under the CSA the participants pooled their respective R&D resources as well as agreed to share R&D costs and risks going forward. The CSA provided Veritas Ireland with the exclusive and perpetual right to manufacture, market, license and sell products using the cost shared intangibles. Under the agreement Veritas US provided Veritas Ireland the right to use its pre-existing know-how, trademarks and trade names and comparable intangible assets. In return Veritas Ireland paid Veritas US a royalty to be adjusted prospectively as well as retroactively in order for the rate to remain at arm's length. Payments consisted of US\$ 6 million, paid in 1999, and US\$ 166 million paid in 2000. The latter payment was adjusted to US\$ 118 million in 2002, so that on balance Veritas US received US\$ 124 million. Veritas Ireland went on to grow in the EMEA, Asia Pacific and Japanese markets without significant assistance from Veritas US. It was able to increase sales by continually upgrading sales resources, providing sales incentives to distributors and finding new customers. The IRS however did not agree with the way in which the license agreement structured the buy-in payment. It recalculated the appropriate buy-in payment using the income method as outlined in the 2007 Coordinated Issue Paper. By doing so it arrived at a buy-in payment of US\$ 2.5 billion and the IRS allocated profit to Veritas US accordingly. The IRS later changed its valuation expert and decreased the allocation from US\$ 2.5 billion to US\$ 1.675 billion. Veritas petitioned against the notice of deficiency with the United States Tax Court.

4.3.4.2. *The United States Tax Court Decision*

The IRS's position in this case was based primarily on the assumption that Veritas US did not just provide Veritas Ireland with the right to use its individual pre-existing know how, trademarks, trade names and comparable intangibles. It also recognized workforce in place, goodwill, going-concern value as well as access to Veritas US' R&D and marketing teams as transferred intangibles. In the IRS's view these intangibles were expected to contribute not only to income anticipated from the sale of existing products, but also to income from sales of future products developed under the CSA. In fact, the valuation expert for the IRS argued that the collective effect of the CSA and the license agreement was "akin" to a sale of business. In his eyes this justified an aggregated valuation of the intangibles transferred taking into account future income from newly developed cost shared intangibles in determining the arm's length buy-in payment.

The US Tax Court did not agree with the IRS on the most principle aspects of the case. On behalf of the Tax Court Judge Foley used harsh language to underline this, when he referred to *"the implausibility of respondent's flimsy determination"*. He considered that the 1995 Cost Sharing Regulations, in force for the years at hand, unequivocally required buy-in payments to be made for certain pre-existing intangibles, but offered no support for the *"akin"* to sale theory or the inclusion of a consideration for workforce in place, going-concern value, goodwill or access to an R&D and marketing team. As such in the Judge's opinion there was also no room for an aggregated valuation:

"Transactions may be aggregated if an aggregated approach produces the 'most reliable means of determining the arm's length consideration for the controlled transactions'. Respondent's 'akin' to sale theory (i.e., a theory which encompasses short-lived intangibles value as if they have a perpetual life and takes into account intangibles that were subsequently developed rather than pre-existing) certainly does not produce the most reliable result."

Judge Foley further did not accept that future income from newly developed intangibles could be taken into account for calculating the appropriate buy-in payment. He emphasized that the Cost Sharing Regulations required buy-in payment to be made with respect to transfer of pre-existing intangible property only. In the Judge's view, attributing income from next generation intangibles to the pre-existing intangibles implies that the latter have a perpetual useful life. The Judge was prepared to accept that the useful life of pre-existing intangibles was four years, but certainly not perpetual. In reaching its conclusion the Judge explicitly took into account that Veritas was *"in a perpetual mode of innovation"* and that its products had *"finite lifecycles"*. In fact, by the time a new product became available, the next generation was already in development. Furthermore, after a remarkable detailed discussion of relevant corporate finance literature the Judge determined that the valuation expert for the IRS used the wrong discount rate to calculate the net present value of future income. The Judge also considered that the expert incorrectly used large and unrealistic growth rates into perpetuity, while the expert did not fully appreciate that Veritas Ireland grew its own markets. This led the Judge to conclude:

"... Veritas Ireland prospered, not because Veritas US simply spun off a portion of an established business and transferred valuable intangibles, but because Veritas Ireland employed aggressive salesmanship and savvy

marketing, successfully developed the EMEA and APJ markets, and co-developed new products that performed well in those markets. For the foregoing reasons, we conclude that respondent's allocations set forth in the amendment to amended answer and at trial are arbitrary, capricious, and unreasonable."

In his decision Judge Foley then went on to consider Veritas' determination of the buy-in payment using the CUT method. For this Veritas had referred to several license agreements that it had concluded with third party original equipment manufacturers ("OEMs"). Veritas had provided these with their products and the OEMs sold the products either bundled with their own operating systems or unbundled as an option. Veritas' valuation expert had used a number of these arrangements, mostly with OEMs selling bundled products, to determine what he felt was an at arm's length buy-in payment. The Judge pointed out that by bundling the products with their own operating systems OEMs added credibility to Veritas' products, improved brand identity and therefore generally paid lower royalty rates. By consequence these arrangements were not regarded sufficiently similar to the arrangement with Veritas Ireland. In respect of the arrangements with OEMs selling unbundled products, the Judge arrived at an opposite conclusion, i.e. those were regarded comparable to the controlled transaction. This was substantiated by a thorough analysis of the functions performed, the contractual terms agreed, the risks assumed, the significant economic circumstances applying and the property or services provided. In respect of all these elements the Judge regarded the transactions to be quite similar and to offer a good comparable for applying the CUT method:

"Although Veritas US' unbundled OEM agreements are certainly not identical to the controlled transaction, an analysis of the comparability factors establishes that the unbundled OEM agreements are sufficiently comparable to the controlled transaction and that the CUT method is the best method to determine the requisite buy-in payment."

The Tax Court's decision further acknowledged that there was additional value in the rights to use the Veritas trademark as well as the sales agreements transferred to Veritas Ireland. Nevertheless, it principally agreed to a buy-in structure applied by Veritas, making only a minimal adjustment to amounts paid by Veritas Ireland.

4.3.4.3. Action on Decision

In fiscal literature the Tax Court's decision was considered a painful blow to the IRS's position on buy-in payments.¹⁶² Shortly after the decision came out Lin and Wright worded that as follows:

*"...this decision seems to be consistent with buy-in analyses that were employed some 25 years ago, before cost sharing arrangements became the subject of highly focused and debated analyses. If one accepts the IRS' statement that its current temporary cost sharing regulations are merely a clarification of existing law, then the Court seems to be sending a strong message that it does not agree with those regulations."*¹⁶³

As such, it might have been expected that the IRS would appeal the decision with the United States Court of Appeal for the Ninth Circuit. However, it did not do so. Instead it issued a notice of non-acquiescence.¹⁶⁴ In this action on decision ('AOD') the IRS explained this strategy by pointing out that it lost the case because of the factual findings by the Tax Court. It still disagreed with these facts, but more principally was disturbed by the additional comments made by the Judge Foley about the general working of the law. Those comments the IRS felt needed to be contradicted in the AOD:

"Because the Court's factual findings eliminated the basis for the Service's valuation, and correspondingly supported the Court's valuation, it was unnecessary for the Court to make the broad assertions it made about the governing law. As those assertions are erroneous and could be inappropriately relied upon by taxpayers in planning future transactions..."

The IRS continued to uphold its view that Veritas US did not only transfer make-and-sell rights, but also the right to further develop existing products and that the combined effect of these interrelated transaction were most reliably valued on an aggregated basis. In a footnote the IRS corrected the Tax Court's interpretation as if the intangibles were assumed to have a perpetual useful lifetime. Instead the IRS indicated to believe that the availability of pre-existing intangibles in addition to make-and-sell rights provided a head start for further R&D that lifted the results from newly developed products during a longer period

¹⁶² See for example: Oates and O'Brien, International Tax Journal 2010/1 and Dau and Ryan, International Tax Journal 2010/2.

¹⁶³ Lin and Wright, International Transfer Pricing Journal 2010/2.

¹⁶⁴ IRS, Action on Decision (Veritas), 6 December 2010, IRB No. 2010-49.

of time then the useful life of the individual pre-existing intangibles. The IRS further objected to Judge Foley's interpretation of the 1995 Cost Sharing Regulations. The relevant Paragraph 1.482-7(g)(2) of those regulations states:

"If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified CSA, then each such other controlled participant must make a buy-in payment to the owner."

The IRS argued that the Tax Court's decision incorrectly focused on the words "*pre-existing intangibles*" to conclude that subsequently developed intangibles are to be disregarded in determining the appropriate buy-in payment. The IRS argued that the words "*for purposes of research in the intangible development area*" are equally important and that these words intent to include income from newly developed intangibles in the calculation of the buy-in payment. In addition the IRS disagreed with the Tax Court's crucial factual finding that Veritas Ireland grew its markets by itself with Veritas US' marketing contributions having no or little value. It also challenged that the access to the marketing and R&D team would have no substantial value.

Nonetheless, the Tax Court decision presented quite an impediment for the IRS. This was strikingly worded by Oates and O'Brien:

*"In VERITAS, the CIP, the temporary regulations and the AOD, the IRS takes the position that the buy-in payment under the cost sharing regulations should value the buy-in aggregate, which in turn gives rise to the IRS view that the buy-in should be valued as a geographic sale of part of the US participant's business. The critical distinction here is that acquisition of a business (including acquisition of the stock of a corporation) by definition takes into account all future cash flows from the enterprise, including cash flows into perpetuity from new products. Here in lies the rub for the IRS: as Judge Foley necessarily and correctly concluded, participants to a cost sharing agreement do not have to pay royalties for intangible property developed under a cost sharing agreement as they are considered co-developers. That, in fact, is the purpose of the cost sharing rules."*¹⁶⁵

¹⁶⁵ Oates and O'Brien, International Tax Journal 2011/1.

Perhaps because it also realized the vulnerability of its own position the IRS recalled the 2007 Coordinated Issue Paper on 26 June 2012 (see Paragraph 4.3.3.4). At the same time however it continued to apply an aggregate valuation for buy-in payments. The arguments for this remained the same and that position was later backed-up by the Obama Administration's proposal in the US budgets for fiscal years 2010 through to 2017 to change the law and expand the Section 482 definition of intangibles to include workforce in place, goodwill and going-concern value.¹⁶⁶ Furthermore, the Treasury and IRS also maintained the income method as the preferred method in the 2011 Final Cost Sharing Regulations and that was not completely without success. Turley, Chamberlain and Petriccione even believe that it caused the income method to replace the declining royalty as the most frequently used standard for calculating buy-in payments:

*"Despite the win for the ramp-down methodology in Veritas, it appears that common practice among US taxpayers has shifted to use of the income method after the release of the 2011 regulations. Whether the shift will prove to be the victory for the IRS remains to be seen: the large number of variables involved in the income method and the high sensitivity of the method to many of the variables (especially discount rates) suggest that buy-in disputes will be as common and as contentious as ever."*¹⁶⁷

Be that how it may, not all taxpayers have accepted the income method. Specifically not those governed by the 1995 Cost Sharing Regulations. One of those was internet retailer Amazon that entered into a CSA with its Luxembourg subsidiary in 2005.

4.3.5. The Amazon Case

Up to 2005 internet retailer Amazon had grown its European businesses as independent silos. Each of the European subsidiaries had their own website in their own national language. They operated separate fulfillment centers, often kept their own inventory and predominantly serviced their own local customers. This operating model led to inefficiencies and limited further expansion. As such there was a legitimate business case for establishing a European headquarters to coordinate future regional activities. It was envisaged that a substantial part of Amazon's future income would be attributable to the intangible property

¹⁶⁶ Budget of the US government for fiscal year 2017, "Analytical Perspectives", Office of Management and Budget, 9 February 2016, page 169.

¹⁶⁷ Turley, Chamberlain and Petriccione 2017, Paragraph 7.2.3.

owned in the European HQ and the coordinating functions performed by the European HQ. Therefore Amazon's tax department was requested to determine a location for the company, where that income would be taxed at a low rate. They considered several countries, including Ireland and Luxembourg. According to the Tax Court's decision Amazon decided to opt for the latter only after meeting with representatives of the Luxembourg authorities, including Mr. Jean-Claude Juncker, Luxembourg's then prime minister. Apparently in Luxembourg they were able to strike a good deal.

The Luxembourg ruling was later found to grant unlawful state aid to Amazon in an investigation by the European Commission, which remarkably enough was at that time chaired by the same Mr. Juncker. From the Commission's letter to Luxembourg in this case it becomes clear that Amazon's Luxembourg structure included several legal entities. At the top of that structure was a limited partnership, Amazon Europe Technology Holdings SCS ("AETH"), which held the intangible property rights associated with the European business as well as all the shares in the second entity, an operating company called Amazon EU Sarl. The employees of the latter entity actually performed activities that resulted in the launch of various new products, a roll-out of advanced new technology and the extension of Amazon's business operations elsewhere in Europe. Luxembourg considered AETH a transparent non-taxable entity, whilst the US considered it a foreign subsidiary of Amazon US. By consequence, the royalty income received by AETH from licensing out its intangible property to Amazon EU Sarl remained untaxed in both countries.

On both sides of the Atlantic the tax authorities chose not to challenge the untaxed position of AETH, but Amazon's transfer pricing arrangements. In the US the IRS focused on the cost sharing agreement, which Amazon US and AETH entered into as of 1 January 2005. Under this agreement a set of intangibles was transferred to AETH, including the software and technology required to operate the European websites, marketing intangibles, website domain names and customer lists. In return AETH made a onetime buy-in payment as well as annual cost sharing payments to cover ongoing development costs. The buy-in payment was determined using the CUT method. Uncontrolled transactions available included those as part of which Amazon provided tailor made e-commerce platforms, services and tools to third party customers that wished to sell their own products online under their own brand names. Using these transactions as well as other comparable open market licensing transactions identified by valuation experts, the buy-in payment was calculated at US\$ 245.5 million. Upon audit the IRS concluded that this outcome was not at arm's length and it recalculated the buy-in payment using the income method. Discounting

future cash flows of AETH over a 20 year period and adding to that a discounted terminal value, the IRS calculated the buy-in payment at US\$ 3.6 billion. Amazon petitioned against the corresponding adjustment of its taxable US income at the United States Tax Court.

Writing for the Tax Court Judge Lauber on 23 March 2017 produced a lengthy and detailed decision covering 207 pages. He did not regard AETH a shell company, probably because for US tax purposes Amazon EU Sarl was a disregarded entity of which the activities were attributed to AETH. The Judge further compared the valuation technique applied by the IRS in *Amazon* and *Veritas* in a manner already indicating that his decision would not be favorable for the IRS:

"One does not need a Ph.D. in economics to appreciate the essential similarity between the DCF methodology that Dr. Hatch [valuation expert for the IRS] employed in Veritas and the DCF methodology that Dr. Frisch [valuation expert for the IRS] employed here. Both assumed that the pre-existing intangibles transferred had a perpetual useful life; both determined the buy-in payment by valuing into perpetuity the cash flow supposedly attributable to these pre-existing intangibles; and both in effect treated the transfer of pre-existing intangibles as economically equivalent to the sale of an entire business."

On the useful life of Amazon's intangibles the Judge found that Amazon was forced to "*leverage the future*", in order to deliver the high level of continuous innovation required to keep up with the competition and increase scale quickly. Its engineers for example built new pieces of software at a high pace, but at the risk that it would not be adaptable to future needs. This resulted in software that became outdated relatively quickly and that had a useful life that was limited, certainly not perpetual. The judge rejected the IRS's arguments that it's valuation expert did not assume a perpetual useful life, after pointing out that the expert's valuation discounted 20 years' worth of cash flows and then added a "*terminal value*". It did not help the IRS that the valuation expert admitted on cross-examination that his methodology produced, in mathematical terms, precisely the outcome that would occur if one assumed a perpetual life.

On the assumption that the buy-in transaction was economically equivalent to the sale of an entire business opportunity the Judge further commented when he discussed the appropriateness of an aggregated valuation. The IRS had argued that this was justified, as the "akin" to a sale theory required an enterprise valuation to be performed rather than "*only*" a valuation of pre-existing intangibles. The Judge disagreed:

"For at least two reasons, the type of 'aggregation' proposed by respondent does not yield a reasonable means, much less the most reliable means, of determining an arm's length buy-in payment... First, Dr. Fitch's business-enterprise approach improperly aggregates pre-existing intangibles (which are subject to the buy-in payment) and subsequently developed intangibles (which are not). Second, his business-enterprise approach improperly aggregates compensable 'intangibles' (such as software programs and trademarks) and residual business assets (such as workforce in place and growth options) that do not constitute 'pre-existing intangible property' under these regulations in effect during 2005-2006."

Furthermore, the Judge in his decision addressed the argument made by the IRS that in determining the buy-in payment the best realistic alternative to cost sharing had to be taken into account. Such alternative would be the possibility to license out the intangibles to AETH instead of entering into the CSA. The IRS positioned that, if dealing with a third party, Amazon would have clearly preferred this alternative to a cost sharing arrangement that allowed a competitor access to its "crown jewels". Again the Judge disagreed with the IRS. He pointed out:

"The transaction actually structured by Amazon US was a cost sharing arrangement, and [the IRS] does not contend that this structure lacked economic substance. The regulations in effect during 2005-2006 unambiguously entitled Amazon US to enter into a qualifying CSA; it cannot be deprived of this entitlement on the theory that it had the alternative of doing something else."

Finally the IRS had requested that, if Veritas could not be distinguished on the facts, it would be overruled. It also contested that Veritas was dictated solely by fact findings and that *"any assertions made by the Court about governing law are dicta and not controlling"*. However, in line with his further decision Judge Lauber did not overrule the decision in Veritas, nor did he characterize the assertions in that case as non-controlling dicta. To the contrary: He concluded that the primary valuation of the IRS was arbitrary and capricious and then went on to state that, if an uncontrolled transaction involving transfer of the same or comparable intangibles under similar or substantially similar circumstances can be identified, the CUT method generally provides the most reliable measure of an arm's length consideration and it was therefore held that Amazon's method

with some appropriate upward adjustments was the best method to determine the requisite buy-in payment.¹⁶⁸

4.3.6. Author's Analysis

In both the Veritas and Amazon case a US parent company employing a uniquely experienced, centralized R&D entered into a CSA with a foreign subsidiary located in a low tax jurisdiction to jointly create valuable innovative intangibles. In other words, both cases concerned taxpayers that would be in the north-eastern quartile "B" of the categorization model presented in Paragraph 2.3.3.2. However, it is quite critical to note that the foreign subsidiaries at hand could, at least from a US tax perspective, not be qualified as a cash box entity. Instead these subsidiaries were attributed skilled personnel that played a crucial part in coordinating and growing their regional businesses. Under the CSA they paid a consideration for the pre-existing intangibles made available by the US parent company. The value of these intangibles was determined by the taxpayers using comparable uncontrolled transactions as a reference, while the IRS advocated a valuation using the income method. That the latter valuation method involved making difficult to test assumptions about the useful lifetime of intangibles, forecasted financial results and the appropriateness of discount rates are all understandable reasons for the Tax Court to prefer the taxpayers' approach better. It seems very reasonable to assume that this will not provide for the most reliable means to value pre-existing intangibles transferred under a CSA, specifically not if there are also appropriate comparables available that could be used for a valuation on the basis of the CUT method.

Be that how it may, Veritas Ireland and Amazon Luxembourg got a very good deal, so good even that I strongly believe that the audited transactions would not have occurred between unrelated parties and that their overall outcome conflicts with the ALS. By entering into the CSA under the terms and conditions outlined above the Irish and Luxembourg subsidiaries received something of value in excess of the access to pre-existing intangibles; a contract under which the US parent commits to making available its resources to on-develop those intangibles into new intangibles co-owned by the subsidiaries in return for a consideration at cost price, i.e. without any profit mark-up. Veritas and Amazon would of course never have committed the same to an unrelated party. The IRS shares this insight, but then quickly takes a wrong turn by seeking to translate the long term commitment in respect of the future development activities

¹⁶⁸ On 29 September 2017 the IRS announced that it would appeal against the Tax Court's decision at the United States Court of Appeals for the Ninth Circuit, where at the time of writing this procedure is still pending.

into items such as workforce in place, going concern value and goodwill that it would like to have compensated as part of the buy-in payment. It subsequently muddles up its position by suggesting an aggregated valuation of those “soft” intangibles and the “hard” pre-existing intangibles such as know-how and technology. One of the reasons why such an aggregated valuation is doomed to fail, is that the commitment in respect of development activities is for a much longer period than the useful lifetime of the pre-existing know-how and technology. This discrepancy is especially amplified, if the taxpayer operates in a very innovative business environment where access to an experienced R&D team is extremely valuable but intangibles have a short lifetime. In other words, the approach chosen by the IRS is specifically ineffective in those situations that under my categorization model can be considered the most likely to cause tax and transfer pricing concerns.

There is another noteworthy angle to the above observation. If Veritas or Amazon had decentralized their development activities and the Irish or Luxembourg subsidiary would have performed a proportional part of such activities, the contributions made under the CSA would have averaged out. However, now that this is not the case the US parent will make overly generous contributions during the whole course of the CSA without receiving an appropriate consideration in return. In my opinion this should be solved by valuing the future cost contributions at market price instead of at cost. The 2008 Temporary and 2011 Final Cost Sharing Regulations on the other hand try to include the value of this commitment in the buy-in payment. That requires complex valuations. As such, it defeats the original purpose of the introduction of the CSA concept, which was to offer taxpayers a safe haven to avoid valuation issues. It also results in disputes that are extremely difficult to litigate. Judges after all are not economists and therefore have a natural tendency to solve transfer pricing issues by allocating the burden of proof among the litigating parties (also see Paragraph 7.2). That involves an increased reliance on the input of valuation experts. The credibility of those experts then becomes crucial. This was lively illustrated by the Veritas case, in which the IRS recalled its first expert’s valuation without clear motivation and then effectively lost the case because of Tax Court’s assessment about the quality of the replacement. As the Tax Court quite relentlessly put it:

"After an extensive stipulation process, a lengthy trial, the receipt of more than 1,400 exhibits, and the testimony of a myriad of witnesses, our analysis of whether respondent's \$1.675 billion allocation is arbitrary, capricious, or unreasonable hinges primarily on the testimony of Hatch. Put bluntly,

his testimony was unsupported, unreliable and thoroughly unconvincing. Indeed, the credible elements of his testimony were the numerous concessions and capitulations.”

In the end the Tax Court rejected the use of the income method in respect of CSAs governed by the pre-2008 Cost Sharing Regulations in both *Veritas* and *Amazon*. By doing so it undeniably rebutted the claim made by the Treasury and IRS that the guidance in the later Cost Sharing Regulations concerning the valuation of platform contributions and the prescription of the income method as a specified method is merely a clarification of existing practice. The Tax Court clearly regarded these aspects to introduce a new approach and decided in favor of the taxpayer, who in the words of the Tax Court in *Veritas* was “*merely required to be compliant, not prescient*”. By consequence, it is still unclear whether valuation of platform contributions using the income method could be in line with the ALS under the post 2008 Regulations. Even if the Courts would adopt this approach, performing a reliable upfront valuation of the commitment to provide development activities at cost price will remain a practical challenge.

4.4. Stock-based Compensation Expenses

4.4.1. Introduction

In 2000 Seagate was again involved in a cost sharing related tax dispute (the first Seagate case was discussed in Paragraph 4.3.2). It now concerned the quite fundamental question of whether expenses related to stock-based compensation of R&D employees had to be shared under a CSA. This second time around, the Tax Court ruled in favor of the IRS¹⁶⁹. Seagate’s request for a summary judgment was rejected and at trial issues of fact remained. Among others evidence was lacking on the factual matter of whether or not third parties would have shared the expenses related to a stock option plan for R&D employees in a similar CSA. As such, the case did not provide for a conclusive decision, leaving the issue open for further discussions.

The amounts involved in stock-based compensation are very significant, especially in the United States where these types of employee incentive programs are quite common.¹⁷⁰ The IRS and Treasury were, and still are, concerned that

¹⁶⁹ Seagate v Commissioner, 22 December 2000, TC Memo 2000-388.

¹⁷⁰ The US National Center of Employee Ownership estimates the value of stock-based compensation plans per end of 2016 at approximately US\$ 1.4 trillion (see <http://www.nceo.org/articles/statistical-profile-employee-ownership>).

US companies will grant their R&D employees share based compensation and claim a deduction against their US taxable profit, while the benefit of the R&D activities lands with (low taxed) foreign affiliated enterprises that have concluded a cost sharing agreement with the taxpayer. Their concern was serious enough to amend the 1995 Cost Sharing Regulations in respect of this point in 2003. Although at that time the 1995 Regulations did in principle require all intangible development costs to be shared unless a specific exception was made (the all-costs-requirement), they did not explicitly address expenses for stock-based compensation. New and extensive wording was added specifically requiring costs attributable to stock-based compensation to be included in the operating expenses shared with other cost sharing participants. Stock-based compensation was defined widely, while detailed rules were provided on how to identify and measure the related costs. In the preamble to the 2003 Regulations the IRS and Treasury took the position that the amendments were only intended to clarify the existing practice. By consequence, even though the new rules only took effect as of 26 August 2003, the IRS also expected taxpayers to include expenses related to stock-based compensation in the shared costs of earlier taxable years. Taxpayers did not agree with this approach and in the 2005 case of *Xilinx v Commissioner* it was tested in court.

4.4.2. The Xilinx Case

4.4.2.1. Facts of the Case

Xilinx Inc. (Xilinx) researches, develops, manufactures and markets integrated circuit devices and related development software systems, so called all programmable devices technology. It was established in 1982 and today positions itself as a leading competitor in the semi-conductor industry.¹⁷¹ In 1994 Xilinx established an Irish subsidiary (Xilinx Ireland) to sell programmable logic devices on the European market as well as to perform research and development activities. In 1995 Xilinx US and Xilinx Ireland entered into a cost sharing agreement under which they each paid a part of their collective research and development expenses in proportion to the anticipated benefits from the newly developed technology. It was stated in the agreement that among others salaries, bonuses and other payroll costs and benefits for R&D personnel would be shared. The agreement however did not specifically address whether expenses related to employee stock options were also covered.

¹⁷¹ www.xilinx.com.

Over the taxable years 1996 up to and including 1999 Xilinx offered its R&D employees two different stock option plans. The related costs were not included in the group's cost sharing. Instead Xilinx claimed a tax deduction for business expenses in its US tax return under Sections 83(h) and 162 of the Internal Revenue Code.¹⁷² The IRS challenged Xilinx position and issued notices of tax deficiency for all four years. In respect of the taxable year 1996 Xilinx and the IRS were later able to resolve the issues among themselves, but for the years 1997 through 1999 their disagreement remained. The tax at stake increased by accuracy related penalties amounted to a very sizable US\$ 97,243,618. This was reason enough for Xilinx to petition the case with the United States Tax Court.¹⁷³

4.4.2.2. *The United States Tax Court Decision*

Before the Tax Court the IRS was not able to provide examples of a similar CSA between third parties under which stock-based compensation expenses were shared. Nor did the IRS dispute the fact that third parties would not "*explicitly*" share such costs. It did contest that third parties would "*implicitly*" share the costs, but in the Tax Court's opinion the IRS failed to explain what it meant by this or present credible evidence that this was actually the case. However that might be, the Tax Court found that there were no suitable comparables. In that context the IRS suggested that the ALS as set out in Section 482 of the Internal Revenue Code did not necessarily require comparing the transaction at hand with transactions between third parties. It argued that an arm's length result would automatically be reached by applying the 1995 Cost Sharing Regulations, which required that all costs related to the collective development of intangibles were to be shared. The IRS believed that this was confirmed by the legislative and regulatory history of the 1986 amendments to Section 482, from which it deducted that Congress had intended to replace the use of comparable transactions with internal measures of cost and profit. The Tax Court did not agree. It made a thorough analysis of the 1986 Tax Reform Act, the 1988 White Paper as well as the 1992 and 1995 Regulations taking into consideration the legislative and regulatory history. It concluded that the rules were unambiguous, that the ALS applied to all transactions and that CSAs were not exempt. Furthermore, it did not find any reason to eliminate the use of comparable transactions in determining Xilinx's taxable income. As such the Tax Court held that the profit allocations proposed by the IRS were arbitrary and capricious, that the alloca-

172 These sections allow for an employer to deduct value of property transferred to an employee connected to employment performance (Section 83(h)) and ordinary and necessary business expenses for compensation for services (Section 162).

173 *Xilinx v Commissioner*, 30 August 2005, 125 TC 37.

tions proposed by Xilinx satisfied the ALS and that Xilinx was not liable for deficiencies or accuracy related penalties.

4.4.2.3. *The First Ninth Circuit Decision*

The Commissioner appealed the Tax Court's decision with the United States Court of Appeals for the Ninth Circuit.¹⁷⁴ The Court of Appeals made its own analysis of the applicable Treasury Regulations. It considered that the general Section 482 Regulations prescribed that in determining the true taxable income of controlled taxpayers the ALS was to be applied in every case.¹⁷⁵ At the same time it recognized that the 1995 Cost Sharing Regulations defined the costs to be shared under a bona fide CSA as all of the costs incurred by a participant related to the collective development of intangibles.¹⁷⁶ Taking into account the Tax Court's factual finding that unrelated parties would not share the costs for stock-based compensation, the Court of Appeals found these two regulations to establish "*distinct and irreconcilable standards*". The conclusion of the Tax Court that the rules were unambiguous was not followed and attempts by both parties to harmonize the regulations were regarded unpersuasive. Left with the question which of the two regulations prevailed, the Court of Appeals applied "*the elementary tenet of statutory construction that where there is no clear indication otherwise, a specific statute will not be controlled or nullified by a general one*". As the Cost Sharing Regulations in this case provided the more specific rule, the Court of Appeals held that the IRS did not take an unreasonable position by requiring Xilinx to share its expenses for stock-based compensation of R&D employees. By doing so the Tax Court appeared to accept that the Cost Sharing Regulations effectively prevailed over the ALS. Along the way the Court of Appeals rejected Xilinx's claim that it did not actually incur costs in relation to its R&D employees' stock-based remuneration. Xilinx pointed out that there was no cash outflow and argued that the costs were in fact for the account of other shareholders, who were confronted with dilution of their equity stake in the company. The Court of Appeals felt that Xilinx's argument was undermined by regulatory language and its own tax returns. It considered that Xilinx could not have claimed a deduction for business expense under Sections 83 and 162 of the Internal Revenue Code, unless it had incurred an *expense*, which in the opinion of the court is the key term in the definition of *costs* under Paragraph 1.482-7(d)(1) of the Cost Sharing Regulations. Finally, the Court of Appeals

174 Xilinx v. Commissioner, United States Court of Appeals for the Ninth Circuit, 27 May 2009, Tax Ct. No. 702-03 and 4142-01.

175 Treasury Regulations Paragraph 1.482-1(b)(1).

176 1995 Final Cost Sharing Regulations, Paragraph 1.482-7(a) and 1.482-7(d)(1).

decided that the IRS's position did not violate the United States – Ireland tax treaty. The Treaty allows for a reallocation of profits from controlled transactions to the extent that “*conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent parties*”.¹⁷⁷ However, under Article 1, Paragraph 4, of the treaty a contracting state may tax its own residents as if the treaty had not come into effect. As in this case Xilinx was a US resident, the IRS could in the Court's opinion refuse a tax deduction for certain costs under the Cost Sharing Regulations without violating the treaty.

The appeal was heard by a three-Judge panel. Following the trail of thought set out above a two-Judge majority consisting of Judges Fisher and Reinhardt reversed the Tax Court's decision and remanded the case. Judge Noonan in his dissent explained that in his view the majority overvalued the-specific-above-the-general canon of construction. Furthermore, he felt that by by-passing the ALS, the court ignored the international context, the Treasury's own practice and the purpose of the United States – Ireland tax treaty to avoid double taxation.

4.4.2.4. *The Revised Ninth Circuit Decision*

The first decision of the Court of Appeals for the Ninth Circuit did not satisfy the taxpayer and received quite some criticism in fiscal literature. As one scholar contested:

*“The Ninth Circuit arrived at a legal and economic conclusion that contradicts the ‘spirit’ of Section 482, disregards tax and international law principles, violates the principle of certainty of law, and punishes a company for acting as uncontrolled parties would.”*¹⁷⁸

On 12 August 2009 Xilinx filed a petition with the Court of Appeals for rehearing or a rehearing en banc. Following this petition the Court on 13 January 2010 withdrew its prior decision without further comment. Subsequently, on 22 March 2010 the original three-Judge panel reissued its decision.¹⁷⁹ It was again based on a two to one majority. Writing for the majority this time Judge Noonan made a similar analysis of Paragraph 1.482-1(b)(1) and Paragraph 1.482-7(d)(1) of the Cost Sharing Regulations as had been done in the withdrawn decision.

¹⁷⁷ 1997 United States – Ireland Tax Treaty, Article 9.

¹⁷⁸ Fontiveros, *Journal of International Taxation* 2010/1.

¹⁷⁹ *Xilinx v. Commissioner*, United States Court of Appeals for the Ninth Circuit, 13 January 2010, Tax Ct. No. 702-03 and 4142-01.

This time the rules were found “*ambiguous*” rather than “*irreconcilable*”. Judge Noonan acknowledged that the Court of Appeals could resolve the ambiguity by applying a rule of thumb that the specific controls the general. However, he pointed out that this solution would be based on a single canon of construction designed to help Judges determine the Legislature’s intent. The Judge preferred to look at the dominant purpose of the regulations instead:

“Purpose is paramount. The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm’s length is trumped by [Paragraph] 7(d)(1) [of the Section 482 Regulations], the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.”

In other words the required parity between taxpayers in controlled transactions and taxpayers in uncontrolled transactions could only be achieved, if Xilinx US and Xilinx Ireland could choose to conclude a CSA without sharing its costs for stock-based remuneration of R&D employees in the same way as uncontrolled taxpayers. Furthermore, Judge Noonan took the United States – Ireland tax treaty and Treasury’s Technical Explanation thereof into consideration from a different perspective than was done in the earlier Court of Appeals decision. He considered that “*the arm’s length standard used in the treaty aids in understanding the mind and practice of the Treasury*”. While in this case the treaty might not constitute binding federal law enforceable in United States courts, it was in the Judge’s opinion clearly concluded under the bilateral assumption that the ALS was the “*readily understandable international measure*” used to allocate profit among controlled taxpayers. The Judge went on to write:

“There is good reason for the standard the Treasury chose: It is an internationally comprehensible standard. It does not require the treaty partner to recognize costs that may have no recognition in its law. If double taxation of the income of parent and subsidiary is to be avoided, a clear, simple, comprehensive standard is needed.”

These quite fundamental statements have been broadly interpreted to reinforce the ALS as the commonly accepted standard of international tax law to be applied consistently and unrestrictedly in all transfer pricing cases. They thus increased the importance of the decision to beyond that of one that merely

provides guidance on the treatment of stock-based compensation under CSAs.¹⁸⁰

Of the three-Judge panel Judge Fisher was the one to change his mind in between the first and the second decision by the Court of Appeals. Concurring with Judge Noonan in the new opinion he especially showed concern about the Commissioners attempt to reconcile the applicable regulations. The Commissioner had argued that unrelated parties concluding a joint development agreement would not expose themselves to an obligation that is dependent on the price of the stock of their unrelated counter parts, while related parties do not have the same problem. As such the Commissioner was of the opinion that there were no appropriate comparables available and that the arm's length result had to be determined by another method than the CUT method. The Commissioner felt that in this case the all-costs-requirement included in Paragraph 1.482-7(d) (1) provided the appropriate guidance. Judge Fisher regarded the Commissioner's reasoning "*complex*" and "*theoretical*". At the same time various Amici Curiae briefs convinced him that Xilinx's alternative interpretation of the regulations was widely shared in the business community and tax profession. This, according to the Judge, showed that taxpayers had not been given clear and fair notice of how the regulations would affect them. At the same time he explicitly mentioned in a footnote that it is still an open question whether this situation changed after the 2003 amendments to the regulations. For now however Judge Fischer agreed with Judge Noonan that the case was to be decided in favor of Xilinx and the judgment of the tax court was to be affirmed.

Judge Reinhardt dissented. He remained convinced that the all-costs-requirement as the more specific rule should prevail over the general rule that the ALS was to be applied in every case. He doubted whether not sharing the costs for stock-based employee remunerations would create more parity between controlled and uncontrolled taxpayers, he objected to the idea that the technical explanation to a tax treaty could trump duly enacted regulations and he questioned whether there was any legal authority for taking into consideration the understanding of the business community and tax profession in the way Judge Fischer did.

¹⁸⁰ In my opinion that however does not mean that the ALS is more than a standard and should be recognized as a principle of international tax law (also see Paragraph 3.2.1).

4.4.3. The 2003 Additions to the Cost Sharing Regulations and the Altera Case

The Xilinx case dealt with taxable years 1997, 1998 and 1999. As stated above, the IRS and Treasury revised the 1995 Final Cost Sharing Regulations on 26 August 2003 to include specifically that expenses for the stock-based remuneration of employees were to be shared among participants.¹⁸¹ In the preamble to the adjustment they argued that this would be consistent with what unrelated parties would agree:

"The regulations relating to QCSAs [qualifying cost sharing agreements] have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles. These final regulations reflect that at arm's length the parties to an arrangement that is based on the sharing of costs to develop intangibles in order to obtain the benefit of an independent right to exploit such intangibles would ensure through bargaining that the arrangement reflected all relevant costs, including all costs of compensating employees for providing services related to the arrangement. Parties dealing at arm's length in such an arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation."

The chosen wording of the new to be included paragraphs of the regulations was quite detailed. It provided a wide definition of what qualifies as stock-based compensation and when it was regarded to be related to intangible development. In principle the measurement and timing of the stock-based compensation expenses had to be consistent with the amounts included as a tax deductible expense in the participants United States income tax return. However, for options on publicly traded stock taxpayers were also allowed to follow the expenses reflected as a charge against income in audited financial statements. If a foreign controlled entity wanted to share stock-based compensation expenses under a CSA with its United States affiliate, this was only allowed for as far the expenses would have been tax deductible to a United States taxpayer. Finally the new regulations provided guidance on how to deal with the re-pricing and other modifications of stock options as well as the expiration or termination of the CSA. These new regulations were later maintained in the 2005 Proposed Regulations, the 2008 Temporary Regulations and the 2011 Final Regulations.

¹⁸¹ 1995 Final Cost Sharing Regulations, Paragraph 1.482-7(d)(2).

After the second decision of the Court of Appeals the IRS could have taken several next steps. It could have asked for a rehearing en banc (i.e. for the full panel), it could have appealed to the Supreme Court or it could have asked Congress to change the law. It could also have issued an Action on Decision of non-acquiescence. It did none of this. Instead on 28 July 2010 the IRS issued an Action on Decision in which it acquiesced in the result, but not the reasoning, of the second Ninth Circuit Decision for taxable years beginning prior to 26 August 2003.¹⁸² The Action on Decision specifically states that the IRS still believes the second Ninth Circuit decision is erroneous. Furthermore, it reaffirms the IRS's opinion that the requirement of Paragraph 1.482-7(d)(1) to share all costs related to the development of intangibles, including expenses for stock-based compensation, does not contradict with the ALS, even if third parties in practice do not share such costs. Nevertheless, the IRS acquiesced, because it believes that the relevance of the second Ninth Circuit decision is mooted by the later amendments to the regulations. This positioning led to new disputes and resulted in the Altera case serving before the Tax Court in 2015.¹⁸³

Altera Corporation is a California based manufacturer of computer chips. Its US parent company, Altera US, entered into a cost sharing agreement with its Cayman Islands affiliate, Altera International. Altera US did not share its expenses for stock-based compensation for R&D employees over the years 2004 through 2007. The IRS disagreed with this approach and adjusted the taxable income of Altera US over these years with more than US\$ 80 million. Altera appealed with the Tax Court arguing that the 2003 additions to the Cost Sharing Regulations do not meet the standard of reasoned decision-making, because they fail to consider that uncontrolled taxpayers do not share these costs. The IRS countered that it is not obliged to determine the taxable profit of controlled taxpayers by reference to third party transactions. In his decision on behalf of the Tax Court Judge Marvel first reviewed the rulemaking process. The IRS had contested that in matters concerning federal tax law the Tax Court should apply different standards when performing such a review. However, the Judge relied on the 2011 decision in *Mayo*¹⁸⁴, in which the Supreme Court stated:

"...we are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly recognized the

¹⁸² IRS, Action on Decision (Xilinx), 16 August 2010, IRB No. 2010-03.

¹⁸³ Altera Corporation v. Commissioner, 30 August 2015, 145 TC 3.

¹⁸⁴ Mayo Foundation for Medical Education & Research et al v. United States, 11 January 2011, 562 US 44 (2011).

importance of maintaining a uniform approach to judicial review of administrative action."¹⁸⁵

Interpreting this to allow for an extensive review, Judge Marvel found that Treasury failed to rationally connect its choice to require the sharing of stock-based compensation expenses with the fact that third parties do not share these costs. He also considered that Treasury failed to respond to significant comments when it issued the new rule. Finally the Judge established that the Treasury's conclusion that this rule is consistent with the ALS is contrary to all of the evidence before it. Therefore, the Judge concluded that the rule fails to satisfy the reasoned decision-making standard as established in earlier non-tax case law¹⁸⁶, declared that the rule is invalid and ruled in favor of the taxpayer. Understandable this was a hard to swallow defeat for the IRS and it therefore appealed the case before the United States Court of Appeals for the Ninth Circuit.

On 24 July 2018 the Court of Appeals' three judge panel in a two to one vote issued an opinion reversing the Tax Court's decision, only to spontaneously withdraw that opinion again on 7 August 2018.¹⁸⁷ The withdrawal means that the opinion holds no authority and that the status on sharing stock-based compensation costs under CSAs is as if the opinion never existed. It should be mentioned that one of the majority judges died before the later withdrawn opinion was published. Although Judge Reinhardt had formally consented with the opinion prior to his death, the withdrawal was explained to "*allow time for the reconstituted panel to confer*". At the time of writing this the timeline for such conferral is still completely unclear. Be that how it may, it can be mentioned that the withdrawn opinion was at publication considered a major win for the IRS. The Court of Appeals founded it on the assumption that with the 1986 introduction of the commensurate with income standard Congress intended to "*displace a comparability analysis where comparable transactions cannot be found*". The Court of Appeals further argued that third parties may not require each other to recognize stock-based compensation cost, but would at least assure "*through bargaining*" that they would be reflected in an arrangement that is in their best interest. Interestingly enough, the dissenting Judge O'Malley not only disagreed with the majority on the appreciation of how Treasury had formalized the 2003 adjustments to the Cost Sharing Regulations, but she also agreed with *amicus curiae* Cisco Systems Inc. that under the best reading of Paragraph 482 the

¹⁸⁵ For a further discussion of the Mayo case also see: Starkey and Cullinan, Journal of Tax Practice & Procedure 2012/4.

¹⁸⁶ Motor Veh. Mfrs. Ass'n v. State Farm Ins., 24 June 1983, 436 US 29 (1983).

¹⁸⁷ Altera Corporation v. Commissioner, United States Court of Appeals for the Ninth Circuit, 24 July 2018 and 7 August 2018, Tax Ct. No. 6253-12 and 9963-12.

commensurate with income standard applies only to the transfer or licensing out of intangibles. The sharing of development costs under a qualifying CSA is neither such transaction and therefore, at least according to Cisco and Judge O'Malley, the commensurate with income standard would potentially not apply to CSAs at all.

4.4.4. Stock-based Compensation Expenses in the Amazon Case

Stock-based compensation expenses were also subject of discussion in the Amazon case, which was already discussed in Paragraph 4.3.5. Amazon's CSA provided for the sharing of these costs in line with Paragraph 1.482-7(d)(2) of the Cost Sharing Regulations, but like many other US taxpayers Amazon had included a claw-back clause in the arrangement that reversed such a sharing of costs, if Paragraph 1.482-7(d)(2) of the Cost Sharing Regulations would be held to be an invalid regulation in a final decision by a court of law. The claw-back would be offset against the cost share of Amazon US in the year in which the triggering event occurs and following years until the claw-back is fully exhausted. However, as the proceedings in *Altera* were not yet concluded when *Amazon* was ruled upon, the claw-back clause was not yet operative by its own terms and Amazon US was rejected a downwards adjustment of its taxable income for the time being.

4.4.5. Author's Analysis

The case law concerning the treatment of stock-based compensation expenses touches on a fundamental aspect of the US Cost Sharing Regulations, i.e. whether or not they can autonomously prescribe under what conditions a CSA complies with the ALS. Blair and Fischer worded this as follows:

"The IRS needs to decide what it is doing when it is prescriptive in its regulations. Is it granting a safe harbor, for which it can set the rules? Or is it trying to tell taxpayers and the courts what is 'arm's length'?"¹⁸⁸

The 2003 additions to the regulations are most certainly prescriptive in nature. However, they were subsequently overruled by the Tax Court in *Altera*, because they would conflict with the assumed fact that non-controlled parties in cost sharing arrangements do not share stock-based compensation expenses. In his decision Judge Marvel discussed in detail the comments submitted by taxpayers in response to the notice of proposed rulemaking and notice of public

¹⁸⁸ Blair and Fisher, Bloomberg BNA 2016.

hearing precedent to the 2003 additions to the regulations. Those explained how unrelated third parties would not share these type of costs because the value is speculative, potentially large and completely outside the control of parties. Some commentators had identified uncontrolled agreements in which stock-based compensation expenses were not shared. Judge Marvel then went on to establish that the Treasury and IRS had not presented any real evidence of the contrary. They had for example not attempted to provide any examples of non-controlled transactions that did include a sharing of such costs.

In my opinion the Court of Appeals for the Ninth Circuit was right to hold in its revised *Xilinx* decision that the ALS prevails over Treasury and IRS regulations. I would also regard it consistent with this decision for the Tax Court in *Altera* to reject such regulations, to the extent that they impose conditions that uncontrolled parties would not have agreed upon in similar transactions under similar circumstances. In applying this test it should be recognized that uncontrolled parties generally do not enter into the type of CSAs that are found between related parties (also see Paragraph 2.2.1). The Treasury and IRS tried to leverage this point in the preamble to the 2003 adjustment of the Cost Sharing Regulations (see the quote in Paragraph 4.4.3). However, that did not convince Judge Marvel, who was especially dissatisfied with the lack of factual substantiation of this position:

"We conclude that (1) by failing to engage in any fact finding, Treasury failed to 'examine the relevant data',... and (2) Treasury failed to support its belief that unrelated parties would share stock-based compensation costs in the context of a QCSA [qualifying cost sharing agreement] with any evidence in the record. Accordingly, the final rule lacks a basis in fact."

As such, the whole matter can be reduced to the following question: Would uncontrolled third parties share stock-based compensation expenses, if they did not have conflicting competitive interests and entered into an agreement similar to a CSA? In my opinion it is very well defensible that the Tax Court found that they would not, given that there was empirical data presented to the Court evidencing that third parties did not require any compensation for share based costs in uncontrolled joint development agreements and there is no evident reason why the difference between such uncontrolled agreements and the CSAs commonly found between related parties would justify a different approach. This is of course very factual and one would expect that does not improve the IRS's chances of a successful appeal. Nevertheless, the later withdrawn opinion issued by the Court of Appeals for the Ninth Circuit on 24 July

2018 was very much in the IRS's favor. It was based on a controversial interpretation of the commensurate with income standard, under which Treasury would under circumstances be allowed to determine transfer prices without using comparables. Needless to say, the further Altera proceedings will be quite critical, not only for the future tax treatment of CSAs, but also for the evolution of the ALS and transfer pricing in general.

In light of this finding it is worth noticing that the whole discussion about stock-based compensation expenses would become far less relevant, if the US would adopt rules that require current contributions to be valued at market price instead of at cost. In that case it would no longer be critical to accurately identify the cost basis, while the profit element included in the value of the contributions could be regarded to offer a certain compensation also for stock-based employment costs.¹⁸⁹ That would then also do right to the observation by the Court of Appeals in its later withdrawn opinion that third parties would compensate for stock-based employment costs "*through bargaining*". In my opinion this further adds to the argument made in Paragraph 4.3.6 in favor of such an approach.

4.5. Conclusions

The key findings of this Chapter 4 are as follows,

In respect of US debate about buy-in payments:

- (i) The US undeniably has a very sophisticated set of rules governing cost sharing arrangements. Despite concerns about cost sharing being applied as a tax planning tool Congress approved the use of "*bona fide CSAs*" in 1986. This has been respected ever since, even if the foreign counterpart under a CSA was a cash box entity located in a low tax jurisdiction.
- (ii) Over the years the use of CSAs was ring-fenced however, specifically by the commensurate-with-income standard and the investor model. These quite fundamental concepts intend to ensure that US cost sharing participants are appropriately rewarded for the contributions they make and the risks they assume under the CSA. In this respect the Treasury and IRS focused primarily on buy-in payments in return for making available pre-existing intangibles.
- (iii) The attempt by the IRS to limit the erosion of the US tax base by requiring higher buy-in payments for pre-existing intangibles fails to recognize the

¹⁸⁹ Also see: Joseph, International Transfer Pricing Journal 2010/4.

true bottleneck of CSA related transfer pricing issues, which is that the US cost sharing rules accept a valuation of current contributions at cost and therefore allow for an under appreciation of valuable functions performed in the course of the arrangement.

- (iv) The IRS advocates a valuation of pre-existing intangibles on an aggregated basis using the so called income method. Such valuation would rely on difficult to verify assumptions about future financial results and useful life of the intangibles at hand. It also would take into account “soft” intangibles, like workforce in place, goodwill and going concern value as compensable assets. All this has been quite explicitly rejected by the Tax Court for years governed by the 1995 Final Cost Sharing Regulations In *Veritas* and *Amazon*. That has significantly limited the effectiveness of the IRS’s approach, specifically in respect of taxpayers with centralized R&D activities that applied a CSA to develop high value innovative intangibles, i.e. those taxpayers that are allocated to the north-eastern quartile “B” of the categorization model presented in Paragraph 2.3.3.2 and that actually are most likely to cause tax and transfer pricing concerns.

In respect of the allocation of stock-based compensation expenses under CSAs:

- (i) The revised decision by the Court of Appeals for the Ninth Circuit in the Xilinx case and the decision of the Tax Court in the Altera case have shown that the Treasury and IRS are bound by the fundamental standard of the ALS when governing CSAs in regulations. Nonetheless, it should remain possible that the commonly held understanding of the meaning and purpose of the standard is further explicated in the Cost Sharing Regulations. It should then also be taken into account that the position of related parties entering into a CSA can differ materially from that of unrelated parties concluding a non-controlled joint development agreement under different terms and conditions.
- (ii) The disputes about the treatment of stock-based compensation expenses are the result of the US practice to value current contributions under a CSA at cost and the focus on cost basis in which that results. It would in principle not be necessary to determine whether uncontrolled participants would share those expenses, if current contributions are valued at market price.

5. OECD

5.1. Introduction

As concluded in the Chapter 3 it can be difficult to apply traditional transfer pricing methods to CCAs. This effect is caused by two specific characteristics of those arrangements. First of all, CCAs generally concern a package deal covering a broad scope of activities performed by multiple participants. This implies a variety of contributions that have to be identified and valued. Obviously this is more complex than a straight forward bilateral transaction covering a single transfer of a property or service. The second fundamentally complicating characteristic is that the allocation of costs and risks under CCAs is based on the anticipated benefits of the individual participants. As most of these benefits will materialize in future years, this requires reliance on financial projections. By definition, that involves a degree of uncertainty and has a subjective element to it. This can be a source of dispute between taxpayers and tax administrations. Taking note of the foregoing this Chapter 5 looks at the OECD guidance on how to apply the ALS in respect of CCAs. While doing so, it also aims to give the reader a better insight into what a CCA is and how it works. For this purpose the analysis is structured around five main focus areas, which in my opinion should be covered by any transfer pricing analysis of a CCA. These are the following:

- (i) the scoping of activities;
- (ii) the selection of participants;
- (iii) the assignment of benefits;
- (iv) the valuation of contributions;
- (v) the calculation of balancing payments.¹⁹⁰

¹⁹⁰ Similar, but slightly different categorizations can be found in fiscal literature. Van Egdom for example identifies (i) the scope of the CCA, (ii) its participants, (iii) the extent in which the value of functions performed is decisive for the share in benefits and (iv) the way in which entry of new participants and exit of existing participants is arranged (Van Egdom 2011, page 168).

The writings below categorize and examine the OECD guidance on CCAs per focus area, while occasionally comparing the guidance to that provided by the United States Treasury and IRS in the Cost Sharing Regulations. Obviously Chapter VIII of the OECD Transfer Pricing Guidelines is designated to CCAs and it is therefore at the core of this examination. At the same time however, it should be noted that this Chapter VIII is intended to provide supplementary guidance only and that all relevant other chapters of the Guidelines also continue to apply. Most relevantly this concerns the provisions of Chapter VI on transactions involving intangibles and Chapter VII on intra-group services.

5.2. Activities

5.2.1. Development Activities and Services

A CCA can cover many types of activities. That includes marketing and R&D activities that may result in innovative intangible assets and can potentially be regarded key value drivers of the group's business. At the same time however the scope of a CCA can also be limited to auxiliary activities like administrative, technical, financial, commercial, legal and accounting services. The broadness of the scope was already recognized by the OECD in the 1979 Report on Transfer Pricing and Multinational Enterprises.¹⁹¹ Ever since, it has consistently considered activities aimed at the development of intangibles as well as intercompany services as part of the potential coverage. This was further emphasized in the revision of Chapter VIII of the Transfer Pricing Guidelines under the BEPS project by introducing an explicit distinction between "*development CCAs*", aimed at the development, production or obtaining of intangible or tangible assets, and "*services CCAs*", aimed at obtaining services.¹⁹²

For completeness sake it can be pointed out that a development CCA requires the actual performance of new development activities. If the purpose of a transaction is only to allow affiliated companies access to another group company's existing intangibles, such transaction is more likely to constitute a transfer or license arrangement rather than a CCA. It would further appear that those new development activities have to be material. For incidental maintenance of existing intangibles or only marginal improvements to existing intangibles a CCA would not appear to be the most logical solution. Furthermore, development CCAs are generally considered more troublesome, because it can be complicated to value contributions and determine the anticipated benefits

¹⁹¹ OECD, "*Transfer Pricing and Multinational Enterprise*", 1979, Paragraph 102.

¹⁹² OECD Transfer Pricing Guidelines, Paragraph 8.10.

under these arrangements. Applying the ALS to development CCAs normally requires close observance of the specific guidance on transactions involving intangibles provided in Chapter VI of the Transfer Pricing Guidelines. In respect of services CCAs on the other hand the specific guidance on low value adding intra-group services provided in Chapter VII of the Transfer Pricing Guidelines is more relevant.

When the EU Joint Transfer Pricing Forum set out to publish an instruction on CCAs in 2012, it also considered the split between development and services CCAs.¹⁹³ As it did not want to interfere with the OECD's ongoing work on intangibles, it consequentially limited the Report to the latter type of CCAs. That Report is discussed in more detail in Chapter 6.

5.2.2. Benefit Test

Tax authorities will generally not allow a deduction of costs for intra-group services, if the benefit from the activities to which the costs are related will not end up in the taxable base of companies located in their jurisdiction. This is commonly referred to as the benefit test. In its 1979 Report the OECD worded it as follows:

*"Any payment for services rendered between associated enterprises would be required or allowed for tax purposes only if a real benefit has accrued to the enterprise that has been charged for such services."*¹⁹⁴

This wording requires MNE's to evidence that a service has indeed been provided, that costs are incurred in relation to it and that a real benefit is conferred on to another group company. Such benefit has to be reasonably expected, but does not necessarily have to be realized in practice. For the benefit to be sufficiently real, it should not be only indirect or remote. Neither should the services merely duplicate a service already being performed by the recipient itself or on behalf of the recipient by a third party. Furthermore, the 1979 Report recognized that it might be relevant whether the recipient would have bought the service had it been on offer from an independent third party. The benefit test was continued in the 1984 Transfer Pricing Report and then reworded in chapter VII of the 1995 Transfer Pricing Guidelines as follows:

¹⁹³ European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period July 2010 to June 2012 and related proposals 1. Report on Small and Medium Enterprises and Transfer Pricing and 2. Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP), 19 September 2012, COM(2012)516.

¹⁹⁴ OECD, "Transfer Pricing and Multinational Enterprises", 1979, Paragraph 151.

*" Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. "*¹⁹⁵

This wording was maintained when the provisions of Chapter VII were replaced in their entirety under the BEPS project.¹⁹⁶ The guidance proceeds to indicate that whether economic or commercial value is provided depends on whether an independent enterprise under similar circumstances would be willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. As such, the criterion whether or not the receiving entity would search for an alternative had the intra-group service not been provided is a key aspect to take into consideration.

That the benefit test correspondingly applies to CCAs does not only follow from the reference to the guidance on intragroup services in Paragraph 8.9 of the OECD Transfer Pricing Guidelines, it is also a direct consequence of the general principle that a CCA is aimed at sharing costs and risks in accordance with the reasonably expected benefits of participants. By definition this requires all participants to expect a benefit from the cost shared activities. That this is the case should be appropriately documented by the taxpayer. A high level contract outlining only the most important terms and conditions under which the services are provided is generally not sufficient. Instead a reasonably detailed description of all departments involved and their activities will have to be available.¹⁹⁷ This of course entails a significant administrative burden on the taxpayer. That same obligation will apply in respect of all intercompany services, irrespective of whether they are performed under a traditional service level agreement or under a CCA. However, it can be less cumbersome to fulfill, if the intragroup transactions are centrally managed and administrated. This can make it easier to keep a central set of documentation evidencing the nature of services performed and, as such, that can be considered an important benefit of a CCA. At the same time, application of the benefit test can be complicated by the often indirect method of allocating costs and risks under a CCA. The indirect method does not provide for a one-on-one connection between the charge and the underlying services. Instead the services benefit multiple group compa-

¹⁹⁵ OECD Transfer Pricing Guidelines, Paragraph 7.6.

¹⁹⁶ OECD/G20, "Aligning Transfer Pricing Outcomes with Value Creation", 5 October 2015.

¹⁹⁷ The burden of proof and the nature and extent of documentation requirements are further discussed in Chapter 7.

nies that are charged a proportionate share of costs on the basis of what is considered to be an appropriate allocation key.¹⁹⁸ This can make it significantly more difficult to prove the benefit conveyed to the service recipient. The OECD acknowledges that this implies a risk of double taxation and apparently accepts this risk.¹⁹⁹ However, it is of course highly unlikely that an MNE would unnecessarily incur external costs. Instead it will expect a real benefit somewhere within the group or avoid the costs. Hence, it should in theory always be possible to identify this benefit and the group company that enjoys it. In my opinion the tax administrations should therefore show restraint, when they consider disallowing indirectly allocated charges because of insufficient benefit. If the taxpayer can evidence that it has actually incurred external costs, a tax deduction should only be denied in clearly abusive situations.²⁰⁰

For completeness sake it can be added that the foregoing does not mean that tax deductibility should be a given in all situations where it is concluded that a benefit is enjoyed. Domestic law in the country of the recipient might still deny a deduction for different reasons than a lack of benefit. An example could be the costs for a stock option plan of R&D employees. If this personnel works on development projects under a CCA concluded between multiple group companies, including the group's Netherlands subsidiary, it might be considered arm's length to share stock based compensation expenses (also see Paragraph 4.4). However, Netherlands tax law includes a general non-deductibility clause in respect of these costs. The Netherlands participant in such a CCA would therefore be denied a tax deduction for its share in the costs for the stock-based compensation plan regardless of the benefit conveyed onto it by the underlying R&D activities.

5.2.3. Excluded Activities

5.2.3.1. Shareholder Activities

While the benefit test has to be passed in respect of every internal cost reallocation, the OECD Transfer Pricing Guidelines identify certain activities that per se do not qualify as an intragroup service and therefore should not be recharged, or cost shared for that matter. The first category of activities to which this applies are the so called shareholder activities. This is based on the assumption

198 The allocation of costs via balancing payments under CCAs is discussed in more detail in paragraph 5.6.

199 OECD Transfer Pricing Guidelines, Paragraph 7.26.

200 For an early critical review of the benefit test see Helderma, Bulletin for International Fiscal Documentation 1995/10.

that there is no benefit recognized for subsidiaries from the activities performed by the parent company in its capacity of shareholder. A study book example of this type of costs is the costs incurred by the legal department for drafting the articles of incorporation for the parent company. Such costs should not be recharged to or cost shared with subsidiaries. At the same time there can very well also be support activities performed by the legal department that undoubtedly do benefit other group companies and for which those group companies would have been prepared to pay a fee to a third party service provider. This could for example concern the drafting of standard sales contracts or the design of general sales conditions. The costs for these activities should indeed be recharged to or cost shared with the benefitting group companies. The Transfer Pricing Guidelines define shareholders activities as activities performed “*solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder*”.²⁰¹ The term “*shareholders activities*” is distinguished from the broader term “*stewardship activities*”. The latter was already used in the 1979 OECD Transfer Pricing Report, but received much less attention there. It covers both non-rechargeable costs of activities for the management and protection of the parent’s investments and rechargeable costs of activities to improve the operation of subsidiaries.

The current guidelines list as prima facie shareholders costs:

- (i) costs relating to the juridical structure of the parent company itself, such as costs for meetings of shareholders of the parent, costs for the issuance of shares in the parent, costs for listing on the stock exchange and costs of the supervisory board;
- (ii) costs relating to the reporting requirements of the parent company, including costs for the consolidation of financial reports, costs for the audit of the parent company’s accounts as well as the audit of subsidiary’s accounts to the extent carried out in the interest of the parent company and costs for the preparation of consolidated financial statements of the group;
- (iii) costs of raising of funds for the acquisition of participations and costs for the parent company’s investor relations such as communication strategy with shareholder of the parent company, financial analysts, funds and other stakeholders in the parent company;

201 OECD Transfer Pricing Guidelines, Paragraph 7.9.

- (iv) costs which are ancillary to the corporate governance of the group as a whole.²⁰²

The 1984 OECD Supplements also included managerial and control activities related to the management and protection of the investment in participations. However, these activities now no longer qualify as *prima facie* shareholder costs. Instead the related costs should be recharged to a subsidiary (potentially under a CCA), unless it can be assumed that an independent entity in the place of the subsidiary would not be willing to pay for the activities nor would have performed them for itself. Another category of costs concerns those incurred when performing so called *mixed activities*, combining elements of both shareholders activities and intra-group services. An example would be the work performed by the accounting department. Their efforts result in annual accounts of the parent, but also enable better operational management decisions at the level of individual group companies.

Shareholders activities are by definition not suitable for cost sharing. Instead it should become clear from the CCA documentation that they are out of scope. For that purpose they are to be left out from the summary of activities covered by the arrangement. For the avoidance of doubt they can also be explicitly excluded. Subsequently this has to be lived up to when operating the CCA. If the arrangement has a broad scope and also covers general support and administrative activities, the taxpayer has to be able to show how it has ring-fenced shareholders costs and excluded them from the identification of contributions as well as the subsequent calculation of balancing payments. That will generally require a transfer pricing report with an analysis of the nature of the different activities performed at headquarters level. To the extent that costs facilitate both shareholder activities and other activities they would either have to be allocated directly or on the basis of an appropriate allocation key. The part that is not related to shareholder activities, should then be recharged to the benefiting group companies. This could be structured as multiple direct charges to those group companies or by means of a CCA.

5.2.3.2. Duplication

A second category of activities that the OECD also does not regard to constitute intra-group services consists of those that merely duplicate a service that is already provided by other group companies themselves or on their behalf.²⁰³ They simply do not provide those other group companies with a real benefit and

²⁰² Idem, Paragraph 7.10.

²⁰³ Idem, Paragraph 7.11.

therefore should not be recharged to them or cost shared with them. Exceptions can apply when the duplication is temporary (e.g. in case of a business reorganization) or when the purpose of the activity performed is to reduce the risk of wrong management decisions (e.g. a second opinion on a legal issue). When the Transfer Pricing Guidelines were revised under the BEPS project the OECD added wording that requires tax administrations to explain why the company would duplicate costs contrary to efficient practices. This also acknowledges that activities performed at different levels within the group can be different, additional or complementary and therefore can still provide a benefit in addition to activities in the same field performed in-house. Obviously, this is closely related to the point made in Paragraph 5.2.2 that a taxpayer cannot be assumed to accept costs unnecessarily.

5.2.3.3. *Incidental Benefits*

The third and final category of activities that the OECD does not recognize as an intra-group service is those activities that provide an incidental benefit to certain group members.²⁰⁴ An example is the costs involved in analyzing the potential acquisition of a new company. The acquisition might lead to synergy benefits for the existing group companies. However, that does not cause the performance of the analysis to qualify as an intra-group service. This is a fair outcome. However, I tend to question whether the incidental nature of the benefit is the decisive element. Instead it appears to be the indirectness of the benefit that is the distinctive characteristic causing the absence of an intra-group service and, by consequence, excluding the underlying activities from being recharged or cost shared. Similarly, benefits arising from only being part of a larger group are often indirect and in that case also do not by themselves cause an intra-group service to be performed.²⁰⁵ A good example is the higher credit rating given to group members by financial institutions, because an implicit guarantee from the parent company is assumed. Such implicit guarantee is not regarded an intra-group service. As such it is not something for which compensation is payable and it should not be cost shared. Explicit guarantees are different. They are regarded a financial service, that should be appropriately compensated for. However, an explicit guarantee is a quite specific type of service. The benefit to group companies will depend on credit ratings of the guarantor and the beneficiary. Calculating it is a specialized financial exercise. It is quite unsuitable for cost sharing. Instead guarantees are more commonly structured as traditional service agreements. Another example of a function where the difference

²⁰⁴ Idem, Paragraph 7.12.

²⁰⁵ Idem, Paragraph 7.13.

between passive and active association can be relevant is sourcing. It is reasonable to expect that a group as a whole will have better buying power than its individual members. By itself that is not a service provided among the group members. Nevertheless, if a more or less centralized sourcing department actively takes over the control of the group's purchasing activities and decides what contracts are concluded with which suppliers, the picture changes and an intra-group service becomes more than likely. In that case it may well be possible to alternatively structure the sourcing activities under a CCA.

5.2.4. Centralized Services

In addition to explicitly pointing out which activities do not convey a benefit onto other group companies and are therefore excluded from being recharged or cost shared, the current OECD Transfer Pricing Guidelines also include examples of activities that in fact do constitute an intra-group service. These were added as part of the revisions under the BEPS project. It concerns:

*"... administrative services such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services; financial services such as supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks, and refinancing; assistance in the fields of production, buying, distribution and marketing; and services in staff matters such as recruitment and training ..."*²⁰⁶

The Guidelines go on to explain that group service centers also often carry out order management, customer service and call centers, research and development or the administration and protection of intangible property for all or part of the group. By consequence, all these activities should be regarded suitable for cost sharing under services CCAs.

5.3. Participants

5.3.1. Mutual Benefit

In parallel to selecting the appropriate activities it is to be determined which group companies should participate in the CCA. The first requirement of the

²⁰⁶ Idem, Paragraph 7.14.

OECD is that each participant should at least expect a real benefit from the CCA activities:

*"Because the concept of mutual benefit is fundamental to a CCA, it follows that a party may not be considered a participant if the party does not have a reasonable expectation that it will benefit from the CCA activity itself (and not just from performing part or all of that activity)."*²⁰⁷

This requirement is closely related to the benefit test described in Paragraph 5.2.2, but it goes a step further. It requires all participants to obtain a benefit from exploiting cost shared results, which means that such benefit cannot be limited to receiving a balancing payment under the CCA. If a group company performs development activities without itself exploiting the resulting intangibles, it would not be exposed to any real risk of the activities being unsuccessful. As such, commercial and financial relations between the group companies would not be in line with the CCA definition requiring a sharing of costs and risks. Instead an accurate delineation of the intercompany transactions would identify the group company performing the activities as a service provider and the other group companies involved as the service recipients. The mutual benefit requirement also implies that if a group has centralized its primary business activities in relation to which the exploitation of cost shared results takes place (for example manufacturing or sales) in a limited number of group companies, then it could be expected that those group companies are identified as cost sharing participants and, by consequence, become the owners of the cost shared results. After all, it would be those group companies that are the key users of those results.

The mutual benefit requirement further entails that the results from the cost shared activities should consist of assets or services that add value to the business operations of *all* participants. Those participants should have been prepared to solicit a third party to perform the cost shared activities or perform these themselves, had they not been performed under the CCA. It further implies that participants should obtain an interest in the assets or services resulting from the cost shared activities. They should be able to exploit such results without any charges in addition to balancing payments under the CCA. This also applies in respect of newly developed intangibles, which participants should be able to use and exploit free of additional royalty charges. The requirement of a mutual benefit was also adopted by the EU Joint Transfer Pricing Forum in its report on

207 Idem, Paragraph 8.14.

CCA's on services not creating intangible property, while the US Cost Sharing Regulations explicitly state that each participant should “*receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest*”.²⁰⁸

For completeness sake it should be noted that all these institutions, the OECD, the EU JTPF and the US Treasury, only require participants to expect a benefit. They do not impose a condition that the cost shared activities in reality have to be successful. To the contrary, the participants should share the risk of under-performance. Therefore, if the actual results are less than reasonably expected, for example because the market demand in a certain group company's region disappoints, that does not mean that such group company was unrightfully qualified as a participant. However, if the situation does not improve over a longer period of time, it may of course be questioned whether there is still a reasonable expectation of a benefit and whether a third party would not have discontinued its participation in the CCA.

5.3.2. Substance

5.3.2.1. Low Substance Participants

As discussed in paragraph 2.4 allowing low substance group companies to participate in a CCA without further restrictions potentially opens up the door to undesired tax planning opportunities. It enables MNEs with facilities in high taxed countries to incorporate a so called cash box subsidiary in a tax haven jurisdiction, which can then participate in a CCA covering the group's future R&D and marketing projects. That way the tax haven subsidiary quite easily obtains an interest in new intangibles and becomes entitled to the income from their exploitation. As such, the subsidiary's participation in the CCA can result in a significant shift of profit from the high tax countries to the tax haven jurisdiction. MNEs using these structures may argue that this is justified by the risk that the cost shared activities are unsuccessful. The potential upside for the cash box subsidiary would be regarded a compensation for its assumption of such risk. Even if it could be assessed that the risk is sufficiently real and at par with the potential benefits of the cash box subsidiary, it still has to be acknowledged that considering low substance entities are able to assume such risk and allowing them to participate in a CCA enables profit shifting by only moving around highly mobile items like cash and risk. By consequence, it would effectively offer MNEs an “*opting out*” opportunity from the domestic tax system.

²⁰⁸ 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(b)(1)(iii).

This can distort the competitive position of smaller business or less aggressive MNEs and undermine the solidarity and the payment moral of other taxpayers. The problem becomes especially apparent in case of organizations that have centralized the development activities of innovative intangibles. They would be concluding CCAs belonging in the northern-eastern quartile “B” of the categorization chart presented in paragraph 2.3.3.2. A participant in such a CCA could be performing all of the development activities, while it would be entitled to only a limited share of the future profits from the resulting high value intangibles.

It is questionable if and how international tax law can resolve the issue. Obviously, it would be sheer protectionism and probably not even practically possible to simply prohibit and thereby completely block the establishment of new business activities abroad to those situations that profits are subject to a minimal level of taxation. It could also be a material overkill expected from such undesirable measure, because it would also impact taxpayers that have valid business reasons to set-up real activities abroad. It is evident that this would hurt economic growth and global prosperity. Furthermore, within a European context it would be in clear breach of the fundamental freedoms as laid down in the Treaty on the Functioning of the European Union. That is not to say that states might not try to discourage MNEs from transferring business to low tax jurisdiction for fiscal reasons only by topping up the tax charge to a certain minimal rate, for example by means of so called CFC legislation. Under such rules income of controlled foreign corporations (‘CFCs’) is conditionally included in the taxable base of the parent company. If a tax credit is granted for the minimal corporate income tax levied abroad, this effectively results in an additional top-up of the tax burden to the level of the statutory tax rate of the country of residence of the parent company. However, in practice many exceptions to CFC rules have been allowed. As becomes clear from the US case studies included in the 2010 Report of the US Joint Committee on Taxation, creative MNEs will exploit these exceptions and plan around the CFC legislation.²⁰⁹ Nevertheless, there may be opportunities to improve CFC legislation or supplement it by modern day alternatives and make it more suitable for addressing base erosion and profit shifting through CCA structures. This is discussed in more detail in Chapter 9.

Meanwhile legislators and policymakers have also identified potential transfer pricing solutions to the problem of tax avoidance through CCA structures. The OECD’s 2015 adjustments to Chapter VIII of the Transfer Pricing Guidelines as part of the BEPS project pursue two such transfer pricing measures. The first measure aims at reversing the profit shift by focusing on the valuation of

209 See Paragraph 2.4.

contributions under the CCA. It tries to increase the compensation payable to the participants that make certain resources available. If contributions consist of performing development activities, their value will generally be higher as the intangibles that are developed are more innovative. By consequence, the measure becomes more effective as the CCA moves to the right on the horizontal axis into the eastern quartiles “B” and “D” of the categorization chart presented in Paragraph 2.3.3.2. Such approach is further discussed in Paragraph 5.5.3.

The second measure does not aim to reverse the profit shift, but instead to avoid it. This measure assumes that the nature of the arm’s length standard sets a minimum requirement for the functions performed and risks assumed by group companies in respect of the cost shared activities in order for those group companies to be allowed access to a CCA. The measure entails a first high-level functional analysis to establish which group companies perform critical management and control functions and actually control the risk associated with the cost shared activities. It therefore sets a minimum substance threshold. Less group companies will meet this threshold, as more relevant functions are centralized. In any case centralization would not be allowed to the extent that local participants lack all management and control functions. As such, this measure targets CCAs that are high up on the vertical axis in the northern quartiles “A” and “B” of the categorization chart. This measure, which will be discussed in more detail in the following paragraphs, is hereafter referred to as the control-over-risk requirement. It effectively denies cash box companies access to CCAs. The concept of control-over-risk was introduced by the OECD in 2009. As we will see, similar tests aimed at verifying the economic reality of commercial and financial relations between CCA participants have also found their way into regulations governing CCAs in countries like Australia and The Netherlands.²¹⁰

5.3.2.2. *The OECD’s Control-over-risk Requirement*

It has taken quite some time for the OECD to clearly express itself about the amount of functional involvement required from participants to a CCA. There was no explicit guidance included on this in the 1979 Transfer Pricing Report, the 1984 Supplements or the original Chapter VIII of the Transfer Pricing Guidelines. The requirement for parties to intercompany transactions to exercise control over the associated risks was first more generally explicated with the introduction of Chapter IX on business restructurings. This addition to the Transfer Pricing Guidelines was adopted by the Committee on Fiscal Affairs on 22 June

²¹⁰ For a pre-BEPS comparative law analysis also see Okten, *International Transfer Pricing Journal* 2013/1.

2009 and approved by the Council on 22 July 2009. It defines the concept of control as follows:

"... 'control' should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions..."²¹¹

Day-to-day monitoring and administration functions can be outsourced, but the risk controlling entity should at least be able to assess the outcome of activities performed. The OECD further illustrates this by examples concerning principals that hire a fund manager, a contract researcher or a contract manufacturer. In all these cases the principal is regarded to have control over the main risks, because he decides on entering into or terminating the agreement, the scoping and objectives of the outsourced activities and the available budget.²¹²

For the assessment of whether sufficient control is exercised all risks that potentially affect the transactions under the arrangement are relevant. This includes funding risk, which is recognized as being *"integrally related"* to risk-taking.²¹³ After all the funding entity is exposed to the risk that it loses its funds. Furthermore, the OECD describes the risks related to transactions involving intangibles in detail in Paragraph 6.65 of the Transfer Pricing Guidelines:

"Particular types of risk that may have importance in a functional analysis relating to transactions involving intangibles include (i) risks related to development of intangibles, including the risk that costly research and development or marketing activities will prove to be unsuccessful, and taking into account the timing of the investment (for example, whether the investment is made at an early stage, mid-way through the development process, or at a late stage will impact the level of the underlying investment risk); (ii) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (iii) infringement risks, including the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming, costly and/or unavailing; (iv) product liability and similar risks related to products and services based on the intangibles;

211 OECD Transfer Pricing Guidelines, Paragraph 9.23.

212 Idem, Paragraph 9.24 - 9.26.

213 Idem, Paragraph 6.60.

and (v) exploitation risks, uncertainties in relation to the returns to be generated by the intangible.”

These risks similarly apply to CCAs aimed at the development of intangibles. Noting this, it should be remembered that a CCA has been defined as a framework agreement aimed at cumulatively sharing costs *and* risks. It is clear that cash box entities can share costs, but it is up for debate to what extent they can also share any risk, let alone those risks described in the quote above. In this context the OECD assumes the position that under arm’s length conditions, parties should be allocated a greater share of risks, if they have more control over such risks.²¹⁴ This should be taken into consideration when trying to answer the question what level of active involvement is required from participants in a CCA. A cash box entity will by definition not have directors or employees that are sufficiently skilled to make any of the decisions necessary to have control over the main risks associated with the cost shared activities. The entity therefore realistically speaking does not assume these risks. By consequence it simply cannot participate in a CCA. The OECD finally included specific guidance confirming this, when it revised the Transfer Pricing Guidelines under the BEPS-project:

“A party would also not be a participant in a CCA if it does not exercise control over the specific risks it assumes under the CCA and does not have the financial capacity to assume these risks, as this party would not be entitled to a share in the output that is the objective of the CCA based on the functions it actually performs ... In particular this implies that a CCA participant must have (i) the capability to make decisions to take on, lay off, or decline the risk-bearing opportunity presented by participating in the CCA, and must actually perform that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, and must actually perform that decision-making function.”²¹⁵

At this stage it is important to acknowledge that the OECD does not rule out that an entity assuming only a funding risk, could still participate in a CCA. Therefore, effectively a distinction is made between cash box entities without any substance and funding entities with sufficient substance to bear a funding risk. Cash box entities are not able to control any risk associated with cost shared

²¹⁴ See Paragraph 3.3.1.2.

²¹⁵ OECD Transfer Pricing Guidelines, Paragraph 8.15.

activities. Funding entities on the other hand would have employees that are capable of making, and actually do make, three relevant types of decisions:

- (i) decisions on entering into or terminating the participation in the CCA;
- (ii) decisions on the type of activities and objectives of the CCA; and
- (iii) budget decisions.²¹⁶

So, while cash box entities are denied all access to CCAs, entities controlling funding risks can still participate, provided they can control the financial risks associated with the cost shared activities. To avoid leaving open a door to profit shifting opportunities, the OECD has however tried to ensure that their potential benefit from the arrangement is limited. This is part of the second transfer pricing measure against the use of CCAs in tax avoidance structures, as is further discussed in Paragraph 5.5.3.4.

5.3.2.3. *The Australian Substance Requirements*

The Australian Taxation Office ('ATO') addressed the issue of cash box participants explicitly in the Taxation Ruling on CCAs that it published in 2004.²¹⁷ Following Chapter VIII of the OECD Transfer Pricing Guidelines the ruling recognizes that the consideration for sharing resources and skills, in part or in whole, comes from the individual exploitation of the cost shared results. It goes on to acknowledge that a CCA avoids the difficulties involved in requiring the separate determination of arm's length prices for the two-way flow of contributions and benefits among the participants. This is illustrated by the case of a CCA between a participant that performs research activities and another that provides funds. In this context the Ruling remarks:

*"Instead of the first participant being rewarded at a market price of cost plus a margin for the research services it has performed for the benefit of the second, and that participant being rewarded by a margin on the funds it has supplied to the benefit of the first, the costs of both might simply be shared and rewarded not through any margins but through commensurate sharing in the expected benefits from use of the results of the CCA activity."*²¹⁸

²¹⁶ Compare the examples provided in Paragraph 9.25 and 9.26 of the OECD Transfer Pricing Guidelines.

²¹⁷ Australian Tax office, Taxation Ruling on Cost Contribution Arrangements, ATO TR 2004/1.

²¹⁸ Idem, Paragraph 72.

By consequence the ruling in principle accepts the possibility of a participant funding cost shared activities without actively performing them itself. However, the ATO does make a crucial reservation in this respect. It refers to another ruling in which it has laid down its fundamental approach of transfer pricing matters. That ruling states clearly that at the end of the day, the outcome of any analysis must make business sense in the context of the particular case.²¹⁹ This means that, also when it concerns participation in a CCA, it should be considered that independent parties would protect their own economic interest. They would compare the options realistically available and seek to maximize the overall value derived from their resources. One of the options then taken into account should be not to enter into the CCA.

This is further explained in several examples annexed to the ruling. Perhaps by coincidence or perhaps to illustrate the fundamental relevance of the matter, the first of these examples addresses cash box participants. In that Example 1 an Australian company ('AusCo') has developed a successful product, which it sells itself. It also licenses out the technology to manufacture the product. The company now intends to start up an R&D project to develop the next generation of the product. AusCo is financially strong and has skills and resources available to perform the necessary R&D activities itself. Nevertheless, it is considering to enter into a CCA with a new foreign group company ('ForCo'), possibly established in a low tax jurisdiction. Under the arrangement AusCo would make available the existing technology and perform the R&D, while ForCo would only contribute cash. In return for sharing in the costs the foreign company would be entitled to license the cost shared technology to other group members for manufacturing and selling the product in their local markets. The ATO considers that under these circumstances it is questionable whether a third party in AusCo's position would enter into the CCA at all:

*"Even if AusCo's contribution of pre-existing technology is valued so as to take account of its future earning potential, there is a question as to why AusCo as an independent party would agree to share the future earning potential of the new technology. If it were concluded that independent parties in the positions of AusCo and ForCo might be expected not to enter into the CCA, we may disregard the arrangement and take the action necessary to produce an arm's length outcome for AusCo."*²²⁰

219 Australian Tax office, Taxation Ruling on Arm's Length Transfer Pricing Methodologies for International Dealings, ATO TR 97/20, Paragraph 1.1.

220 Australian Tax office, Taxation Ruling on Cost Contribution Arrangements, ATO TR 2004/1, Paragraph 195.

As the example makes apparent, a CCA would not pass the Australian test of making business sense and would therefore be disregarded by the ATO, to the extent it includes participants that lack the necessary substance to control the risks associated with the cost shared activities.

5.3.2.4. *The Netherlands Substance Requirements*

The Netherlands Ministry of Finance issued a decree outlining the Dutch interpretation of the OECD Transfer Pricing Guidelines in 2001. This was subsequently updated a number of times, most recently in 2018.²²¹ It includes a section on CCAs with five stylized examples. Two of them illustrate how the Dutch authorities require participants to exercise control over risks along the lines of the OECD Transfer Pricing Guidelines. The first of these examples is lettered M and concerns three associated companies A, B and C that are all involved in the development, manufacturing and selling on their local markets of consumer products. They enter into a CCA to develop a new product. They contribute equally to the structuring of the research program and the decision taking per identified research phase, including the strategic project planning and coordination. Furthermore, Company A contributes existing technology, company B contributes resources (personnel and fixed assets) and company C contributes cash to cover expected third party costs. Each participant's contribution is valued equally at approximately € 2 million. Companies A, B and C each become legal and effective owner of the results for as far as they pertain to their own markets. They are expected to benefit equally from the individual exploitation of the new products. Under these circumstances the decree regards the CCA to lead to an arm's length result. This shows that the Ministry of Finance does not upfront exclude group members like Company C, who's involvement in the actual performance of research activities is limited to a funding contribution, from sharing in residual profits.

The other example in the Dutch decree that is relevant in this context is lettered O. It features two associated companies A and B. Company A is involved in the development, manufacturing and selling of consumer products. Company B employs only two people with a financial and administrative background. Company A has performed initial research into the development of a new product. This is potentially suitable for exploitation on the local markets of both companies A and B. They enter into a CCA under which Company A contributes the results of the initial research. In addition to the contractual agreement it is determined that Company A also coordinates and controls all further develop-

221 Decree of the Netherlands State Secretary of Finance, 22 April 2018, no. 2018-6865.

ment activities, which includes taking all key R&D related management decisions as well as actually performing the day-to-day R&D activities. Company B contributes 50% of the fair market value of the initial development results and 50% of the actual further development costs. Under the CCA both companies would share the effective ownership of the resulting intangibles to the extent these pertain to their own markets, while company A would become the sole legal owner of such intangibles. According to the Dutch decree the outcome of the CCA in this example is not at arm's length. The Dutch decree reaches this conclusion by acknowledging that Companies A and B have contractually agreed to share all risks associated with the cost shared activities, while Company B lacks the functional capacity to control those risks associated with the management of R&D activities. According to the Dutch Ministry of Finance the latter risks should therefore be allocated exclusively to Company A and the compensation of both companies should be adjusted accordingly. That does not mean that Company B is excluded as a participant. It does after all control the funding risks associated with its participation in the CCA. However, the profit of Company A would be increased to include all benefits from the sale of the new products with the exception of a risk adjusted return compensating Company B for the funding it provided (also see Paragraph 5.5.3.4). As such, the Netherlands tax administration explicitly requires participants in a CCA to have the expertise and resources to control the risks they contractually assume and, by doing so, follows the OECD's guidance in this context.

5.3.2.5. *Author's Analysis*

The use of low substance entities in tax structures was undoubtedly one of the major concerns when the OECD started its BEPS-project in 2012. To combat this, risk assumption was made a focus point of the revision of the Transfer Pricing Guidelines. Rather surprisingly the only place where the revised OECD Transfer Pricing Guidelines explicitly address cash box entities is in an example.²²² Nevertheless, a new section on risk assumption included in the revised guidance on the delineation of transactions provides relevant insights, specifically on the control of funding risks.²²³ The amendments to Chapter VIII of the OECD Transfer Pricing Guidelines on CCAs build on this to exclude group companies from participation, if they do not have the capacity to control the risks associated with cost shared activities or they do not regularly exercise such control. This control-over-risk requirement has a logic to it. In fact, as explained in Paragraph 4.3.2.2, it is the natural consequence of the intention under the ALS to have

²²² OECD Transfer Pricing Guidelines, Paragraph 1.103.

²²³ See Paragraph 3.3.1.

controlled transactions take place under circumstances that are consistent with those of the open market. It should be noted however that under the revised OECD guidance a group company whose only contribution consists of passively funding cost shared activities can still qualify for participation, provided it employs sufficiently experienced personnel that make the critical funding decisions. The benefit of these group companies from their participation in the CCA should however be limited to a risk adjusted return. In my opinion the practical consequence of drawing such a thin line, is that only the most marginally furnished entities are excluded from participation. Any company with a minimal level of active business operations and a corresponding amount of substance can participate (under the Dutch decree two employees with a financial background would suffice). The tax administrations of Australia and the Netherlands have adopted rules with similar consequences in their national regulations. The ATO and the Dutch Ministry of Finance both allow for participants to make only cash contributions, but are restrictive when it comes to low substance participants. Under circumstances, they will disregard their participation in a CCA. For this purpose, Australia considers whether the CCA at the end of the day makes business sense, while the Netherlands requires all participants to control the risks associated with their contributions. In contrast, the United States has traditionally not imposed any substance requirements on participants. Alternatively, the Treasury and IRS have tried to limit the return of cash box participants by making pricing adjustments under the existing arrangement, specifically by claiming higher buy-in payments from the low substance participants. Perhaps the US approach is more aligned with the principle that a pricing adjustment should always be considered first and that non-recognition of an arrangement can only be a measure of last resort. Furthermore, from a US internal perspective it can perhaps be argued that not positioning substance requirements corresponds best with the intention of congress to limit the curtailing of CCAs as much as possible. However, the approach unavoidably leads to additional discussions about the appropriate size of a buy-in payment. This has forced the Treasury and IRS to publish extensive regulations. As a result the taxpayers that Congress wanted to accommodate, those using bona fide CCAs, are faced with the complex valuation issues on pre-existing intangibles. This is remarkable, given that CCAs were initially intended to reduce the number of valuation disputes. Meanwhile, aggressive MNEs still appear prepared to take on the challenge of a valuation conflict and up to now they have been successful when advocating these in front of the courts.²²⁴ I therefore, as stated already several

224 For a discussion of the Veritas and Amazon case see Paragraphs 4.3.4 and 4.3.5 respectively.

times in Chapter 4, much prefer the application of a control-over-risk requirement to an approach aimed at imposing high platform contributions on cash box entities.

5.3.3. Controlled Non-Participants

5.3.3.1. *Free Riding*

As discussed in the previous paragraphs an overly broad scope of participants including group companies with insufficient mutual benefit or substance will cause an outcome that is not in line with the ALS. There can also be situations in which the same effect occurs because of the opposite reason, i.e. the number of participants is too limited. This can be the case if non-participating group companies benefit from the cost shared activities, while they do not pay compensation to the participants community for assuming the costs and risks related to those activities. These controlled non-participants would in fact be free riding. For completeness sake it can be pointed out that free riding does not per se infringe directly upon the interest of an individual participant. It can also consist of the exploitation of cost shared results in a way that does not harm any of the parties to the CCA directly. The obvious example would be if a controlled non-participant would use cost shared know-how for the manufacturing and selling of products on a territorial market in which none of the participants is active. Obviously a third party would not be granted the right to use the know-how without paying an appropriate compensation.

The free rider problem is eliminated, if controlled non-participants benefiting from the cost shared results pay a royalty, service fee or other form of compensation to the participants community. If this is effectively shared among the appropriate participants on the basis of the same allocation key as development or services costs under the CCA, the outcome should be acceptable again. Naturally the size of the compensation paid as an alternative to participating in the CCA would have to be at arm's length, i.e. equal to what a third party would have been prepared to pay for a license under similar circumstances. This means that the specific situation of the controlled non-participants has to be considered. That might well differ from that of participants. By consequence, the size of an appropriate royalty or service fee is not necessarily equal to the amount that the outsider would have been charged had it been a full-fledged participant in the CCA. For example a controlled non-participant can have the same access to cost shared intangibles and make similar use of them as participants. As such it equally benefits from results. However, the controlled non-participant will generally enter into the license agreement once the development of the intan-

gibles has been completed. By consequence it generally does not share in the risk of failed projects. This places the outsider in a favorable position, for which a third party might well have been prepared to compensate the participants community by paying a royalty that exceeds the contributions that it would have paid as a participant. The opposite can also occur. A licensee might only have limited access to cost shared intangibles, it may make limited use of the intangibles or it may be required to further develop them before they are suitable for exploitation on its own market. A service recipient might have a more limited need for services, because it obtains them elsewhere or it performs the activities itself. In these cases the controlled non-participant is in a less favorable position than participants and it can be appropriate for the royalty or service fee paid to be less than the contributions that would have been payable by a full-fledged CCA participant.

5.3.3.2. Author's Analysis

It should be noted that under certain circumstances MNEs can have an incentive to allow controlled companies to exploit cost shared results without paying an appropriate royalty or services fee. This may have a fiscal background. For example it might be difficult to claim a tax deduction for CCA charges, royalties and service fees under local law in the country of residence of the controlled non-participant or such charges might be subject to a withholding tax. Alternatively an MNE might allow free riding because the associated company is not 100% owned by the group. In that case the MNE might not want to share results in the same way as it does with fully owned subsidiaries or the joint venture partner might not accept the cost sharing charge. By not adequately addressing the free riders issue the OECD omits to provide guidance on the appropriateness of conditions under which the participants community transacts with controlled non-participants. However, it is evident that the tax treatment of intragroup charges in the non-participant's country of residence cannot offer a valid reason for exempting the non-participant from paying an appropriate consideration for the activities from which it (co-)benefits. If the MNE in such a case does allow for free riding because of tax reasons, then tax administrations can be expected to adjust taxable profits to reflect the free riders' share in costs and risk.

If the reason for a group company not to participate in the CCA originates from the relationship with a joint venture partner, better arguments may exist for a differing size of the royalties and service fee or even the absence thereof. The terms and conditions of this relationship are after all the outcome of negotiations between two unrelated parties. The MNE might not want to grant effective ownership to joint ventures in the same way as it does to fully owned subsidiaries

and the joint venture partner might not want to share in the costs of the MNE's centralized activities. Whatever the situation, it should be kept in mind that under Article 9 of the OECD Model Tax Convention the joint venture company is still an associated enterprise, as long as the MNE directly or indirectly participates in its management, control or capital. As such all circumstances relevant in respect of the relationship with the joint venture partner will have to be taken into consideration, when determining whether there is any free riding going on. If such an analysis leads to the conclusion that conditions have been imposed that differ from those that would have been agreed between unrelated parties, there will still be a risk of (or indeed a need for) profit adjustments.

5.4. Benefits

5.4.1. Identifying Benefits

Just like with any other commercial transaction parties enter into a CCA, because they expect it will render them certain benefits. In fact, under the distinguishing characteristic of a CCA, those anticipated benefits are the basis for participants to be allocated costs and risks. Determining whether the outcome of the arrangement is at arm's length requires turning this around to determine whether the size of the benefit of each individual participant justifies the costs it incurred and the risks it assumed. Be that how it may, the anticipated benefits are a crucial element and they need to be properly identified. Nevertheless, the guidance by the OECD on the matter does not go any further than remark that *"some benefits can be determined in advance, whereas others will be uncertain"*.²²⁵ This is very short and therefore leaves quite some room for uncertainty and disputes.

Among others the existing OECD guidance does not provide any insight on how to deal with benefits that are completely unforeseen. That this might pose a problem is illustrated by the example of an MNE from the semiconductor industry that cost shares a project to develop a next generation computer chip. The group companies of this MNE decide that the expensive, high-tech equipment used in the R&D process is to be legally owned by the individual group companies. However, the maintenance and depreciation costs related to the equipment are proportionally allocated among participants. When more advanced equipment becomes available, it is agreed to replace the models currently in use. They are sold off on the second hand market at a price exceeding book value. The ques-

225 OECD Transfer Pricing Guidelines, Paragraph 8.6.

tion then comes up to what extent that gain should be identified as a benefit from cost shared activities and how it is to be divided between the participants. The agreement underlying the CCA may provide for an allocation of the benefit. On the other hand it might not do so explicitly, if the benefit from selling off the old equipment is unforeseen. Nevertheless, there might in that case still be indirect guidance deducted from the way in which specific risks related to the equipment are shared under the arrangement. If the legal owners exclusively bear the risk that the equipment should perish, it could make sense for them to also have the full entitlement to any upward potential. If that risk is shared among participants it could be more reasonable to also share the benefit. Alternatively, it could be argued that apparently the cost shared depreciation was determined at a too high amount and should be reversed resulting in a repayment of balancing payments by the participant that legally owned the equipment. Another factor to take into account is whether the equipment was used exclusively for cost shared activities or also for other activities. A pro rata split of the gain on sale could be required. With detailed guidance missing, it will be up to tax practitioners themselves to come to a reasonable analysis that takes into account all relevant facts or circumstances.

5.4.2. Assigning Benefits

The OECD guidance is not only very limited when it comes to identifying CCA benefits. In respect of the assignment of those benefits there is also very little to go by. Paragraph 8.6 of the OECD Transfer Pricing Guidelines recognizes that *“each participant’s interest in the results of the CCA activity should be established at the outset”*, but says nothing about how to do so. There is only a lone example indicating that in case of a development CCA a perpetual, royalty-free license for the territory in which participants operate would be an option. The US Cost Sharing Regulations offer some more direction. They suggest a division of benefits based on territories or field of use.²²⁶ In case of a division on a territorial basis the entire world has to be split up in territories, which subsequently all have to be assigned to participants. They should be entitled to the perpetual, non-overlapping and exclusive right to exploit the cost shared results through the use, consumption, or disposition of property or services in their territories. Obviously there is some overkill in the requirement to cover the entire world, if it is clear from the start that none of the participants will be active in certain territories. The refrigerator company will after all not be selling to the Eskimos.

226 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(b)(4)(ii) and (iii).

For a division on the basis of field of use under the US Cost Sharing Regulations, all possible uses of cost sharing results have to be identified. Subsequently they should all be assigned to individual participants, who each should be granted the perpetual, non-overlapping and exclusive rights to exploit the cost sharing results through at least one of those uses. Furthermore, any unanticipated uses should be assigned to a single participant. An example of a field of use assignment is offered by the MNE selling consumer electronics that cost shares its marketing effort to develop a new brand and then assigns the use of the brand for the sale of desk- and laptops to one participant, the use of the brand for the sale of tablet computers to a second and the use of the brand for the sale of mobile phones to a third. It is however unclear to me why the Cost Sharing Regulations prescribe that benefits are assigned to just one participant, to the extent that they result from the use of such brand in ways that were not anticipated at the time of entering into the CCA, for example its use for the sale of “smart” watches or glasses. In my opinion there is no principle objection against taxpayers assigning those benefits proportionally to multiple or even to all participants.

Although a division on a territorial or field of use basis is considered most common, the Cost Sharing Regulations also allow for alternative divisions provided that:

- (i) the interest in cost shared results is clearly and unambiguously divided among the participants;
- (ii) recordkeeping by the MNE enables the checking of a consistent application;
- (iii) the participants’ exploitation rights are perpetual, non-overlapping and exclusive;
- (iv) it should be possible to predict with a reasonable reliability, the resulting benefits per participant.²²⁷

As an alternative assignment method participants may for example be allowed the rights to use cost shared results at their own manufacturing sites. However, what method is most appropriate will always depend on the nature of the activities performed under the CCA. I believe that specific assignment methods may

227 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(b)(4)(iv).

be easier to identify, if the cost shared activities result directly or indirectly in new products or services which the participants can exploit. They are therefore more likely to be available, when the cost shared activities are aimed at generating additional profit. If on the other hand the cost shared activities are aimed at realizing a cost saving, a more general description of how benefits are assigned may have to be used. Provided this results in a sufficiently unambiguous assignment, participants can in my opinion simply be assigned benefits from the cost shared results *“to the extent it pertains to their business”*.

5.5. Contributions

5.5.1. Introduction

As the OECD points out in paragraph 8.3 of the Transfer Pricing Guidelines the transfer pricing issues in respect of CCAs relate to *“the commercial or financial relations between the participants and the contributions made by the participants that create the opportunities to achieve those outcomes”*. Those contributions can come in different shapes and sizes and they can be made at different moments in time during the course of the CCA. In order for the arrangement to comply with the arm’s length standard each participant’s proportionate share of contributions should be consistent with its proportionate share of expected benefits. If necessary, participants should pay each other balancing payments to reach a situation in which this is the case (see Paragraph 5.6). In order to test the proportionality it is crucial to establish the *overall* contributions of the combined participants. These will first have to be identified and subsequently valued. The valuation of contributions, specifically the valuation of contributed pre-existing intangible assets, has been one of the focus point of the OECD’s recent work on CCAs.

5.5.2. Identifying Contributions

5.5.2.1. Terminology

The OECD recognizes that certain contributions have a so called pre-existing value. They involve assets obtained or developed by the contributing participant or participants externally from the CCA and are referred to as pre-existing contributions. Although this choice of words can be confusing, I believe these contributions do not necessarily have to exist already at the time the CCA is concluded nor is it required that they are contributed at the outset of the arrangement. It can also involve assets that were obtained or developed by the contrib-

uting participant externally from the cost shared activities, but contemporaneously to those activities and then contributed under the CCA. The textbook example of a pre-existing contribution is manufacturing technology owned by one of the participants that is contributed for further development so that the participants can manufacture a next generation of products. Such pre-existing technology is owned exclusively by the respective contributing participant. It is something different from the more advanced technology that is created by the performance of the cost shared activities. The latter technology is a separate intangible, which is co-owned by all of the participants community. Pre-existing contributions are to be distinguished from current contributions. The latter type of contributions consists of the performance of cost shared activities. They are by definition made in the course of the CCA. While pre-existing contributions are comparable to the transfer or licensing of assets, current contributions are more alike to the performance of services.

5.5.2.2. Salaries, Tangible Assets and Third Party Costs

Obvious contributions are the salaries of personnel that performs the cost shared activities and the costs for tangible assets that are used in the process. This can involve both internal and external costs. It may concern employees on the ground involved in day-to-day operations as well as higher management taking key decisions at a certain distance. The tangible assets that are used could among others consist of materials, equipment, software and laboratory or office space. Participants can also decide to outsource all or part of the cost shared activities to a non-participating outsider. In that case the payment of the outsourcing fee qualifies as a contribution. The outsourcing partner could be an unrelated third party or a group company that does not expect to exploit the results itself and therefore cannot participate in the CCA. This would for example be the case, if the group has centralized activities in a special purpose entity that is not involved in operational activities.

The outer limits of what does and does not qualify as a contribution are not undisputed. A good example are expenses for the stock-based compensation of employees. If these employees work on cost shared activities, it would under the benefit test *prima facie* seem appropriate to share those costs with the entire participants community. However, there are two arguments to be made against this. The first argument assumes that expenses for stock-based compensation actually do not constitute a cost for the employer. The issuance of new shares to employees does not imply a cash out nor does it negatively impact the financial position of the employer. Instead the cost is effectively for the account of the employer's shareholders, who are faced with a certain dilu-

tion of their equity stake in the company. The second argument assumes that third parties would not share these costs as they would be reluctant to expose themselves to an obligation that is dependent on the price of the stock in an unrelated counterpart. This led to issues in the United States, where taxpayers were not only granted a deduction but also an R&D related tax credit in respect of these costs. Obviously this provided a strong incentive for the Treasury and IRS to argue that the costs were to be recharged. They tried to achieve this by including a requirement for sharing these costs in the US Cost Sharing Regulations. However, the revised regulations were subsequently overruled by the US Tax Court (Paragraph 4.4.2 and 4.4.3).

5.5.2.3. *Intangible Assets*

5.5.2.3.1. *Platform Intangibles and Make-Sell Rights*

The contribution of salaries and tangible assets can be distinguished from making available intangible assets. As already addressed earlier, the OECD qualifies such intangibles as pre-existing contributions. They may be used to perform the cost shared activities or they might be further developed into new intangibles. The difference can be illustrated by comparing two different CCAs of taxpayers from the computer gaming industry. The first arrangement is aimed at developing a completely new computer game with one or more participants making available their pre-existing programming know-how. The second CCA intends to develop the sequel to a popular existing so called shooter game, which was originally designed by one of the participants. In the first instance the programming know-how is used instrumentally to produce a new stand-alone intangible asset. In the second situation the contributed pre-existing intangible serves as the basis for developing the next generation of an existing product. The latter type of pre-existing intangibles is also referred to as “*platform intangibles*”.

It should be acknowledged at this stage that any contribution of intangibles under a CCA differs materially from granting so called make-sell rights. The latter would involve limited rights to use intangibles for the manufacture or sale of a product, without the intention to further develop those intangibles or to use them for developing new intangibles. Transactions involving make-sell rights are generally structured as a license arrangement under which the licensee pays a periodic royalty to the licensor in return for access to the intangibles. In these situations there is no transfer of the effective ownership of the intangibles to the licensee. By consequence the licensee is not entitled to the proceeds from the intangibles other than those generated by its own use of the intangibles

within the scope of the license arrangement. In my opinion make-sell rights are fundamentally different from a contribution under a CCA and should generally be evaluated and priced on a separate basis.²²⁸

5.5.2.3.2. *The OECD Definition of Intangibles*

To properly identify all contributions under a CCA consisting of intangible assets, a good understanding of the definition of “*intangibles*” is required. A revised definition was introduced in a discussion draft published by the OECD in June of 2012, which was followed by a revised version only a year later.²²⁹ The project was subsequently incorporated into the more comprehensive work on base erosion and profit shifting, which eventually resulted in the current Transfer Pricing Guidelines defining intangibles as:

*“...something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.*²³⁰

This is an autonomous definition, independent of the qualification for accounting and legal purposes. It is therefore not required that these intangibles are capitalized on the balance sheet. Neither do they per se have to be suitable for legal or contractual protection. Furthermore, intangibles under the OECD’s definition do not necessarily have to be individually transferable and hence may be inseparable from other business assets.

The Transfer Pricing Guidelines list patents, know-how, trade secrets, trademarks, trade names, brands, contractual rights and government licenses as examples of intangibles.²³¹ They also point out that licenses and similar agreements offering the right to use intangibles can themselves qualify as an intangible asset. The same applies for other rights from contractual arrangements, such as agreements to make available the services of one or more employees.²³² Other assets not explicitly mentioned in the report that may be regarded intangibles are for example copyrights, formulas, data and customer lists. The OECD further addresses the position of goodwill and ongoing concern value. Various definitions of goodwill are possible, all of which recognize good-

²²⁸ This is also confirmed in Paragraph 1.482-(c)(4) of the 2011 Final Cost Sharing Regulations.

²²⁹ OECD, “*Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*”, 30 July 2013.

²³⁰ OECD Transfer Pricing Guidelines, Paragraph 6.6.

²³¹ Idem, Section A.4.

²³² Idem, Paragraph 6.25.

will as the excess value in a combination of business assets compared to their stand-alone worth. This is elaborated upon in Chapter XI of the OECD Transfer Pricing Guidelines, where an ongoing concern is described as a functioning, economically integrated business unit.²³³ Transferring such ongoing concern implies not only the transferring of assets but also the ability to perform certain functions and bear certain risks. In that case it may, according to the OECD, be most reliably to measure the value of the multiple contemporaneous transactions involved on an aggregated basis. This valuation should then reflect all valuable elements that would also be compensated for in uncontrolled situations. However, goodwill or ongoing concern value are not qualified as intangible assets. Instead their exact legal status is considered irrelevant for transfer pricing purposes. They are simply considered an element to be taken into account when valuing transactions involving the interrelated assets that together constitute an operating business.

Concepts that the OECD explicitly excludes from the definition of intangibles are group synergies, an assembled workforce and market specific characteristics. As is also discussed in paragraph 3.3.2.2, these are so called comparability factors that impact the price at which controlled transactions should take place, but they cannot be qualified as intangibles for the purpose of Chapter VI of the OECD Transfer Pricing Guidelines.

5.5.2.3.3. The US Definition of Intangibles

As already acknowledged in paragraph 5.3.2.5, the United States has been trying to counter the use of CCAs for off-shoring profits by requiring higher compensation under the investor model for non-cash contributions, specifically contributed platform intangibles. In this context the Treasury Department and IRS introduced the concept of platform contribution transactions ('PCTs') in the 2008 Temporary Cost Sharing Regulations and continued to use this in the 2011 Final Cost Sharing Regulations.²³⁴ Assets that would potentially constitute a platform contributions are not limited to only "*intangibles*" as defined in section 936(h)(3)(B) of the Internal Revenue Code. The latter intangibles are limited to any:

- (i) Patent, invention, formula, process, design, pattern, or know-how;
- (ii) Copyright, literary, musical, or artistic composition;

²³³ Idem, Paragraph 9.93.

²³⁴ 2011 Final Cost Sharing Regulations Paragraph 4.482-7(c)(1).

- (iii) Trademark, trade name, or brand name;
- (iv) Franchise, license, or contract;
- (v) Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or
- (vi) Any similar item, which has substantial value independent of the services of any individual.

Platform contributions on the other hand would also include an assembled workforce, goodwill and ongoing concern value. Especially in respect of assembled workforce the preamble to the 2011 Final Cost Sharing Regulations includes very explicit wording. First an example is provided of a participant contributing the commitment of an experienced research team to the development of new intangibles under a CCA. The preamble states:

"To limit the arm's length charge in these circumstances to sharing the ongoing salary costs would ignore the value of having the particular research team already in place to undertake the intangible development with the benefit of its particular knowhow."

To emphasize that the same can also apply for services outside the field of R&D, it then continues:

*"As another example, the contribution of core entrepreneurial functions such as a product selection, market positioning, research strategy, and risk determinations and management requires an arm's length charge under these regulations. To omit charges for these or any other significant economic contributions one controlled taxpayer makes for another's benefit would fail to clearly reflect the incomes of such controlled taxpayers."*²³⁵

It is not questioned that the salary costs of the assembled workforce are qualified as cost contributions and shared among the participants community. However, the unique experience of the employees involved is considered to have an extra value, which justifies that the participant that assembled the workforce externally from the CCA receives an additional compensation through a

²³⁵ 2011 Final Cost Sharing Regulations, preamble.

PCT. By consequence, an assembled workforce, goodwill and ongoing concern value are under the Cost Sharing Regulations qualified as items that themselves are capable of being owned, controlled and transferred in a PCT, i.e. as intangible assets. The Cost Sharing Regulations do not take them into account as a comparability factor when valuing the performance of R&D activities, but instead regard these elements to be part of a platform contribution consisting of an intangibles and services package. In the eyes of the Treasury and IRS this package constitutes a business opportunity that has to be valued on an aggregated basis taking into account the income from new intangibles developed under the CCA.

In the 2007 Coordinated Issue Paper discussed in Paragraph 4.3.3.4, the IRS field agents were instructed to already apply the above approach to CCAs that existed prior to the 2008 Temporary Cost Sharing Regulations entering into force on 5 January 2009. This led to disputes with taxpayers and eventually resulted in litigation. In the Veritas case, which can be considered a landmark case in the history of transfer pricing disputes, the United States Tax Court quite bluntly rejected the inclusion of assembled workforce, goodwill and going concern value as transferred intangibles. In respect of the assembled workforce Judge Foley explicitly referred to the definition of section 936(h)(3)(B). He pointed out that in his view it was not an item “*which has substantial value independent of the services of any individual*”.²³⁶ Apparently the Judge was of the opinion that the value of an assembled workforce comes from the services of individual employees and therefore does not qualify as an intangible under the definition of the Internal Revenue Code. Although the Veritas decision was very clearly in favor of the taxpayer, it did not end the debate. The IRS rejected the decision in a notice of non-acquiescence.²³⁷ It disagreed with both the factual findings and the legal reasoning of the Tax Court. At the same time the IRS acknowledged that it was highly unlikely to be successful in applying its extended intangibles definition in fiscal years that ended before the 2008 Temporary Cost Sharing Regulations were even published. Therefore, the coordinated issue paper was recalled on 26 June 2012. However, the cost sharing regulations were not amended and the IRS has continued to advocate a broad intangibles definition ever since. This then led to further discussions and a second unfavorable ruling for the IRS in the Amazon case.

Meanwhile the Obama administration in its 2010 budget proposal tried to improve the position of the Treasury Department and IRS by amending the

²³⁶ Veritas Software Corporation & Subsidiaries, et al. v. Commissioner, United States Tax Court, 12 October 2009 – see Paragraph 4.3.4 for more details.

²³⁷ IRS, Action on Decision (Veritas), 6 December 2010, IRB No. 2010-49.

intangible definition in the Internal Revenue Code to include workforce in place, goodwill and going concern value.²³⁸ This proposal has been repeatedly positioned in slightly amended form up to the 2017, after which it was not continued by the Trump administration.

5.5.2.3.4. *Authors Analysis*

By labeling “soft” intangibles like workforce in place, goodwill and going concern value platform contributions, the Treasury and IRS try to create a basis for increasing buy-in payments to be paid as a consideration for the contribution of pre-existing intangibles by US based CCA participants. I have repeatedly indicated that I am not in favor of such an approach. It leads to difficult to resolve valuation issues, as encountered in Veritas and Amazon (see Paragraph 4.3). Furthermore, it results in complex discussions about the cost base and what part of it should be shared, as seen in *Xilinx* and *Altera* (see Paragraph 4.4). After the analysis in this Paragraph 5.5.2.3 two additional arguments can now be brought forward as to why the referenced soft intangibles should not be compensated for in platform contribution transactions. First of all, it would be inaccurate and inconsistent from a theoretical perspective to not qualify concepts like workforce in place, goodwill and going concern value as what they actually are: comparability factors determining the value of resources made available in the course of the CCA. Secondly, doing so nonetheless has an unjustifiable timing disadvantage for the taxpayer, because it frontloads taxable income to the moment of the platform contribution, which is very often at the outset of the CCA. That would disregard that from a group perspective income is only realized when the results from cost shared activities are exploited. It can be argued that this is compensated by discounting the income stream in the valuation of the platform contribution, but that still leaves a severe cash flow constraint. This is also not completely taken away by structuring the platform contribution transaction as a royalty instead of a lump sum, as such royalty would logically decline (or “*ramp-down*”) over the useful life time of the pre-existing intangibles and therefore still would not match cash inflows. Those, after all, can come from the exploitation of newly developed intangibles, which might continue even after the CCA is terminated.

All the foregoing issues are avoided, if workforce in place, goodwill and going concern value are excluded from the platform contribution transaction and instead taken into account as a comparability factor when valuing current

²³⁸ Budget of the United States Government, Fiscal Year 2010, Office of Management and Budget, www.budget.gov.

contributions at market price. I therefore appreciate that this is exactly what the revisions of the OECD guidance under the BEPS-project propose as a main rule.

5.5.3. Valuing Contributions

5.5.3.1. Cost vs. Market Price

The OECD considered already in the 1979 Report and its 1984 Supplements that it would be appropriate to include a profit-mark up in the valuation of contributions under a CCA. The OECD then distanced itself from that initial positioning by stating in the 1997 version of Chapter VIII of the Transfer Pricing Guidelines that the valuation issue was not decisively addressed and would require additional guidance, specifically in respect of whether contributions should be valued at cost (excluding a profit mark-up) or at market price (including a profit mark-up).²³⁹ Subsequently, the US Treasury and IRS introduced the concept of platform contributions in the 2005 Proposed Cost Sharing Regulations. Not only did the new regulations require the buy-in payment to offer market price compensation for pre-existing intangibles, it also had to include a consideration for the ex-ante commitment to make later contributions available at cost. Finally, the OECD in the revision of Chapter VIII under the BEPS project firmly restored the valuation at market price as the main rule for all contributions. However, taking note of the new US approach, the revised guidance foresees in two possible exceptions.

The first exception allows for a valuation of current contributions at cost, if these contributions are preceded by an appropriately higher valued pre-existing contribution:

*"While all contributions should be measured at value..., it may be more administrable for taxpayers to pay current contributions at cost... If this approach is adopted, the pre-existing contributions should recover the opportunity cost of the ex-ante commitment to contribute resources to the CCA."*²⁴⁰

To the extent there was any doubt about whether this exception was included to accommodate the US tax administration, the OECD adds the illustrative example of a participant making available the services of its pre-assembled group of R&D experts. These would normally be priced taking into account the

²³⁹ OECD Transfer Pricing Guidelines, Paragraph 8.1 (old).

²⁴⁰ Idem, Paragraph 8.27.

unique computation of the team. Nevertheless, the OECD allows for a valuation at cost, provided that the added value of this specific workforce in place is taken into account when determining the value of a pre-existing contribution. The example appears to be a one-on-one copy of that included in the preamble to the 2011 Final Cost Sharing Regulations (see Paragraph 5.5.2.3.3).

The second exception to the rule of a valuation at market price is of a very practical nature. The OECD recognizes that in certain cases cost would be a practical means to determine the relative value of current contributions.²⁴¹ That could be the case, if the difference between cost and market value is limited. However, this is considered unlikely to apply to development CCAs and, instead, the exception is intended to primarily be applied in respect of services CCAs. Most notably this exception would be an appropriate solution for CCAs that aim to allocate costs related to low value adding services. If these services are predominantly provided by one of the participants, it would appear reasonable to include a fixed profit mark-up. However, that would still offer taxpayers a relatively easy to administrate arrangement. It also aligns the Transfer Pricing Guidelines with the EU Joint Transfer Pricing Forum's report on CCAs not creating intangibles discussed in Chapter 6.

5.5.3.2. Valuing Pre-existing Contributions

5.5.3.2.1. Introduction

As already mentioned in paragraph 1.7 above, it is not the intention of this study to provide a detailed examination of various specific valuation techniques. Nevertheless there are some general remarks to be made about the valuation of pre-existing contributions, most relevantly those pre-existing contributions that consist of intangibles. When determining such value the guidance from previous chapters of the OECD Transfer Pricing Guidelines is to be taken into account, specifically that included in Chapter VI. This provides an overview of the most critical aspects to observe when determining an arm's length price for transactions involving intangibles (Paragraph 5.5.3.2.2). It outlines the OECD's view on the application of valuation techniques (Paragraph 5.5.3.2.3) and potential issues concerning so called hard to value intangibles (Paragraph 5.5.3.2.4).

²⁴¹ Idem, Paragraph 8.28.

5.5.3.2.2. *Critical Elements of Transactions Involving Intangibles*

The fundamental elements of a transfer pricing analysis of transactions involving intangibles can be found in Paragraph 6.139 of the Transfer Pricing Guidelines. When in absence of appropriate comparables a transfer pricing method other than the CUP method is used to determine the value of intangibles in a controlled transaction, the OECD requires attention to be paid to the following:

- the functions, assets and risks of the respective parties to the transaction;
- the business reasons for engaging in the transaction;
- the perspectives of and options realistically available to each of the parties to the transaction;
- the competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles;
- the expected future economic benefits from the transaction; and
- other comparability factors such as features of local markets, location savings, assembled workforce and MNE group synergies.

An illustrative example of how these elements can impact a transfer pricing analysis of transactions involving intangibles is offered by the decision of the US Tax Court in *Bausch & Lomb*. The case concerned the pricing of a classic license agreement between a US company and its Irish affiliate. Considering elements that in effect are similar to those listed above, the Tax Court came to the decision that the US company was sold short:

“In the normal licensing situation, each party possesses something unique which is necessary for exploitation of a particular project. For example, one party may possess the production technology and the other possesses the capital and marketing expertise. A license agreement is negotiated since neither party possesses all of the attributes needed to exploit the product on its own. Here in contrast, B&L possessed both the productions technology and the marketing network necessary to produce and sell soft contact lenses. B&L Ireland merely had the capital, a nonproprietary asset which theoretically could have been supplied by any number of entities. Thus, B&L

*Ireland would have found itself in a weaker bargaining position vis-à-vis B&L.*²⁴²

There appears to be no reason why this reasoning should not also apply to transactions under a CCA. In other words: A transfer pricing analysis of a transaction involving intangibles, including a valuation of pre-existing contributions under a CCA, should, like any other transfer pricing analysis, be based on the value in use of the intangible for each of the parties to the transaction. The eventual arm's length price is then to be determined somewhere in between the range set by these different values, depending on the relative bargaining power of the parties involved determined by considering the above listed elements.

5.5.3.2.3. Valuation Techniques

Valuation standards for transfer pricing differ from those for other purposes, such as corporate finance and financial reporting. While the OECD has adopted the ALS for transfer pricing valuations, the International Valuation Standards Council (IVSC)²⁴³ uses the so called market value standard. Market value is defined as:

*"...the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion."*²⁴⁴

The International Accounting Standards Board (IASB) on the other hand uses the so called fair value standard. Fair value is defined as:

*"...the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."*²⁴⁵

The OECD acknowledges that a valuation under the market value or fair value standard differs from a valuation under the ALS and may not be appropriate for transfer pricing purposes. It specifically recognizes an *"inherent conservatism"*

²⁴² Bausch & Lomb Inc v. Commissioner, United States Tax Court, 14 May 1991.

²⁴³ The IVSC is an independent not-for-profit institution from the private sector that produces and implements universally accepted standards for the valuation of assets across the world in the public interest.

²⁴⁴ International Valuation Standards Council, IVS 104: Bases of Value, 7 April 2016.

²⁴⁵ International Accounting Standards Board, IFRS 13: Fair Value Measurement, 12 May 2011.

in valuation assumptions made for accounting purposes, which could lead to “valuation approaches that are not necessarily consistent with the arm’s length principle”.²⁴⁶ However, it is not only potential conservatism that plays a role here. As Wittendorf has also written, there are more fundamental differences between the arm’s length standard and the other two valuation standards.²⁴⁷ The ALS focusses on an actual transaction between specific associated parties. It considers the subjective, entity-specific value of the asset involved for each of those parties taking into account their specific situation (also compare the critical elements listed in Paragraph 5.5.3.2.2). Furthermore, the ALS looks at the relative bargaining position of parties. It then seeks to determine the transfer price that would have been used in the same transaction by unrelated parties under similar circumstances. The market value and fair value standards on the other hand assume a hypothetical transaction on a hypothetical market. In other words these standards consider at what price the owner could sell its asset to a random buyer. This is a one-sided approach aimed at determining an objective, market-based value.

Proper recognition of the differences between valuation standards described above leads to the conclusion that valuation for investment or accounting purposes cannot necessarily be relied upon for transfer pricing purposes. Nevertheless, the Transfer Pricing Guidelines do not upfront endorse or reject any valuation standard, nor do they give a mandatory prescription of a specific valuation technique.²⁴⁸ They do however strongly discourage the use of a valuation on a cost basis, because there is considered to be little correlation between the costs of intangibles and their value.²⁴⁹ With the CUP method often ruled out due to a lack of comparables, it may be necessary to resort to valuation techniques that estimate the discounted value of projected cash flows, even if that requires relying on difficult to verify financial projections. The OECD, like the US Treasury and IRS before it, specifically embraces the income method:

“... application of income based valuations techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be particularly useful when properly applied.”²⁵⁰

246 OECD Transfer Pricing Guidelines, paragraph 6.155.

247 Wittendorf, Tax Notes International 2011/3.

248 OECD Transfer Pricing Guidelines, Paragraph 6.156.

249 Idem, Paragraph 6.142.

250 Idem, Paragraph 6.153.

It subsequently however provides only general guidance on the application of income based techniques.²⁵¹ These considerations include the following:

- Financial projections are regarded more reliable when they are not prepared exclusively for tax purposes but also for non-tax business planning purposes.
- Growth assumptions should reflect a likely pattern of revenue and expense development, this is unlikely to result in simple linear growth rates.
- Discount rates should be based on the specific conditions and risks impacting the anticipated cash flows. This means that discount rates are not necessarily equal to the taxpayer's Weighted Average Cost of Capital (WACC).
- The useful life of an intangible can depend on the term of legal protection as well as the rate of technological development in the industry. Platform intangibles however may also result in cash flows from the exploitation of next generation intangibles beyond their own expiration.
- Valuations are performed on an after tax basis, considering tax on projected cash flows, tax amortization benefits and taxation as a consequence of the transfer.

The income based valuation technique that in my own experience is most frequently used in practice is the so called relief-from-royalty method. This makes use of benchmark reports indicating a reasonable royalty for the type of intangible that is being valued. Such royalty would commonly be expressed as a percentage of sales. Under the relief-from-royalty method a hypothetical royalty stream would then be determined considering forecasted sales during the expected useful life of the intangible. This royalty stream would be discounted to reach a net present value that should equal the value of the intangible.²⁵²

²⁵¹ This guidance is much more high level than the very detailed instructions on the use of specific valuation methods found in the US Cost Sharing Regulations (see Paragraph 4.3.3.3).

²⁵² For a detailed analysis of income-based valuation techniques also see Wittendorf, International Transfer Pricing Journal 2010/5 and 6.

5.5.3.2.4. Hard to Value Intangibles

Chapter VI of the OECD Transfer Pricing Guidelines further includes guidance on the transfer pricing treatment of so called hard to value intangibles ("HTVIs"). These are defined as:

*"...intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparabile exists, and (ii) at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer."*²⁵³

Subsequently possible features of transactions involving the transfer or use of HTVIs are listed. For the purposes of this study it is quite relevant that the Transfer Pricing Guidelines explicitly recognize that HTVIs are sometimes used in connection with or developed under a CCA or similar arrangement.²⁵⁴ Obviously that should not be interpreted to mean that every intangible used or developed under a CCA is per definition a HTVI. A cost shared intangible should only be regarded as such, if there is a lack of comparables and the future profits related to the intangible are uncertain. However, it will not be uncommon for both of these conditions to be met and then the further guidance on HTVIs becomes critically important.

Understandably the OECD argues the information asymmetry between taxpayers and tax administrations poses a serious challenge in respect of the transfer pricing treatment of HTVIs. It makes it difficult for tax administrations to determine the arm's length nature of transfer pricing arrangements involving these type of assets. The possibility that this is exploited by taxpayers to transfer high value intangibles to low tax jurisdictions at prices below market value was one of the main concerns that the OECD intended to address with the revision of the Transfer Pricing Guidelines under the BEPS-project. To counter this form of profit shifting, different measures were introduced that offer tax administrations more room to make transfer pricing adjustments, when the actual results from the exploitation of HTVIs deviate substantially from the forecasted results on which the originally agreed compensation for such intangibles was based. First of all, it is considered that third parties might include price adjustment

²⁵³ OECD Transfer Pricing Guidelines, Paragraph 6.189.

²⁵⁴ Idem, Paragraph 6.190.

clauses in the terms of agreements involving HTVIs to cover these situations.²⁵⁵ In absence of such clause unexpected deviation in results might inspire third parties to set out to prospectively renegotiate their agreements.²⁵⁶ If either of the two is the case, the tax administration would be permitted to adjust transfer prices accordingly. It should be noted here that, contrary to the US Cost Sharing Regulations²⁵⁷ the OECD Transfer Pricing Guidelines do not foresee in a strict numeric test determining when a retroactive adjustment is to be made.

Furthermore, the new wording somewhat controversially sanctions the use of ex post outcomes as presumptive evidence about the appropriateness of ex ante pricing arrangements, provided it is given sufficient consideration whether *"the information on which the ex post results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into"*.²⁵⁸ In other words the OECD excludes the use of ex post information, if the taxpayer could reasonably not be expected to have foreseen the facts and circumstances that resulted in the difference between forecasted and actual results. The OECD Transfer Pricing Guidelines list the following situations, in which the foreseeability condition is not met and therefore tax administrations should refrain from making a transfer pricing adjustment on the basis of ex post results:

- (i) The taxpayer provides evidence that (i) the applied transfer pricing was based on financial projections that took into account all reasonably foreseeable events and risks and (ii) the difference between forecasted and actual results is due to unforeseen facts and circumstances.
- (ii) The transfer pricing is covered by a bilateral or multilateral APA.
- (iii) Considering actual results instead of forecasted results would not lead to an adjustment of more than 20% of the compensation for the HTVI.
- (iv) More than five years have passed since the HTVI first generated unrelated party revenues and in each of these years the ex post results were within the 20% safe haven mentioned under (iii) above.²⁵⁹

²⁵⁵ Idem, Paragraph 6.183.

²⁵⁶ Idem, Paragraph 6.184.

²⁵⁷ See Paragraph 4.3.3.3.1.

²⁵⁸ OECD Transfer Pricing Guidelines, Paragraph 6.188 and 6.192.

²⁵⁹ Idem, Paragraph 6.193.

The new HTVI approach has attracted criticism in fiscal literature.²⁶⁰ The OECD tried to rebut that by pointing out that use of ex post results cannot be considered the same as the use of hindsight, if the foreseeability analysis is properly applied. I believe that the before mentioned information gap between taxpayers and tax administration justifies a sanity check based on ex post results and agree with the OECD that a foreseeability analysis is the right backstop to keep it reasonable. At the same time, opening the door to ex post results will undoubtedly inspire tax authorities to more frequently initiate transfer pricing adjustments. The OECD also acknowledges this and suggests that more generous access to mutual agreement procedures offers a solution.²⁶¹ That is good and well, but, as will be discussed in Chapter 10, there are reasons to be concerned about whether such procedures are effective enough to serve that purpose, especially when it comes to CCAs between participants from more than two countries.

5.5.3.3. *Valuing Current Contributions*

According to the OECD the value of current contributions is not based on the value of the cost shared results. Instead the latter value should be reflected in the valuation of pre-existing intangibles and the sharing of risks in proportion to expected benefits.²⁶² Consequently, the value of the current contribution is determined exclusively by the value of the functions performed by the contributing participant. In combination with the requirement that all participants themselves control the risks associated with the cost shared activities to the extent that it pertains to their business, I believe this places the participants performing such activities in a position comparable to that of a contract researcher or a similar limited risk service provider. As such, those participants should receive a similar compensation. If a comparable uncontrolled price is available, that could be used for price setting purposes. Under conditions it could also be appropriate to value functions performed at cost plus a profit mark-up. The OECD however rightfully does not consider a cost-plus valuation appropriate in all cases. Instead Paragraph 8.26 refers to Paragraph 6.79 of the Transfer Pricing Guidelines which explains that the value of, for example, research activities depends on “*all the facts and circumstances, such as whether the research team possesses unique skills and experience relevant to the research, assumes risks (e.g. where ‘blue sky’ research is undertaken), uses its own intangibles, or is controlled and managed by another party*”. It may be argued that in respect of CCAs the skills and experience are the more relevant aspects to take

260 Fedusiv, International Transfer Pricing Journal 2016/6.

261 OECD Transfer Pricing Guidelines, Paragraph 6.195.

262 Idem, Paragraph 8.26.

into account. After all, the assumed risks are proportionally shared, the more material use of own intangibles qualifies as an individually valued pre-existing contribution and the control and management by another party constitutes a separate current contribution of its own. However, if these skills and experience in fact make the contribution unique and valuable, the transactional profit split method could also be considered as a means to determine an arm's length price. As also explained in Paragraph 3.3.2.1, such a method would involve determining the revenue of all CCA participants stemming from the current contribution at hand, the costs associated with the contribution and an appropriate profit splitting factor.

5.5.3.4. *Valuing Funding Contributions*

As already pointed out in Paragraph 5.3.2.2 above, a group company can be allowed access to a CCA, even if its only contribution consists of providing the necessary funding for cost shared activities. A hard condition however is that the funding entity effectively controls the associated funding risk. At the same time, that does not necessarily mean that the OECD considers the group company entitled to share in the excess returns from cost shared results. Instead, according to Paragraph 6.62 of the OECD Transfer Pricing Guidelines the benefit of a group company passively funding activities should generally not exceed an appropriate risk adjusted return. This limitation on funding returns is also a key assumption made in example 4 of Chapter VIII of the Transfer Pricing Guidelines, which involves a CCA between two group companies. One of these, company A, provides funding, while the other, company B, provides pre-existing intangibles and performs further development activities. The realistic funding alternatives should then be taken into account and that then leads to a valuation of Company A's funding contribution at an amount equivalent to its funding commitment plus a risk adjusted return. In other words, a fixed risk adjusted return for passive funding only is the standard. That implies that the funding entity would have to transfer any income from its own exploitation of the cost shared result in excess of such return to the other CCA participants as balancing payments. This seems very reasonable, given that it can be assumed that third parties would not allow for a provider of funds to share in excess returns, if they could also borrow elsewhere against a limited fixed interest rate. That does not mean that determining the risk adjusted return is always a simple exercise, as is also evidenced by Polonska after an analysis of funder's remuneration in private equity examples.²⁶³

²⁶³ Polonska, International Transfer Pricing Journal 2018/2.

5.5.3.5. *Author's Analysis*

I agree with the OECD that for a CCA to have an arm's length outcome contributions should principally be measured at market value. After all, under the ALS each participant should be appropriately rewarded for the functions it has performed, the assets it has used and the risks it has assumed for the purpose of making contributions under the arrangement. If pre-existing contributions would be valued at cost, then the participant making those contributions would not be rewarded for developing or obtaining those contributions for its own account and at its own risk, to the extent that the cost shared results are exploited by other participants. If current contributions would be valued at cost, then the value added by the functions performed in order to make these contributions would go under rewarded. At the same time it should be acknowledged that, although theoretically correct, a rule to value contributions at market value implies a large number of valuation issues, administrative complexity and, by consequence, a serious risk of disputes and double taxation.

When it comes to the valuation of contributions, it is clear that the US has had a strong influence on the content of the OECD Transfer Pricing Guidelines. With the amendments made to Chapter VIII, the OECD follows the US approach to place most emphasis on the valuation of pre-existing contributions (referred to in the US as platform contribution transactions). Often such contributions will consist of HTVIs, of which the value depends on the further application of new developed intangibles. From a US perspective that value should also be included in the compensation for the ex-ante commitment to contribute certain specific resources (e.g. the services of a uniquely qualified R&D team). In line with the Cost Sharing Regulations, the Transfer Pricing Guidelines suggest a valuation technique based on a discounted value of future cash flows. Economists have pointed out that by doing so the OECD sets a very complex and highly contentious approach to achieving an arm's length result.²⁶⁴ Obviously major challenges are posed by the inherent uncertainty about financial forecasts, growth assumptions, discount rates and the life expectancy of the intangibles at hand. This appears to be in direct conflict with the original purpose of the CCA concept to avoid valuation disputes.

Furthermore, the OECD places taxpayers under more pressure to get their valuations right by allowing tax administrations to take into account ex post results when retroactively testing the outcome. As said, the OECD takes the position that this is not the same as using hindsight, because tax administrations should refrain from transfer pricing adjustments, if taxpayers can proof that

²⁶⁴ Wright, Keates, Lewis and Auten, *International Transfer Pricing Journal* 2016/2.

results were impacted by unforeseeable facts and circumstances. The Transfer Pricing Guidelines however leave ample room for dispute about what qualifies as evidence and how much of that is needed. As such, the hindsight discussion is not completely neutralized. It also surfaced in the United States, when the Treasury and IRS included detailed rules on periodic adjustments to platform contribution transactions in the Cost Sharing Regulations.²⁶⁵ Commentators criticized these rules as inconsistent with the arm's length standard, because they would strip away returns from legally assumed risk retrospectively.²⁶⁶ To the extent that the US Cost Sharing Regulations automatically adjust any return outside of the predefined range, they do indeed disregard that, as Wright, Keates, Lewis and Auten put it, third parties could just have entered into a bad deal.²⁶⁷ The Treasury and IRS counter this argument by claiming that "*in determining whether to make any periodic adjustments, the Commissioner considers whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances*". However, without explicit instructions for the Commissioner to focus on the appropriateness of the arrangement at the time the arrangement was entered into, I seriously doubt whether any post ex result outside of the prefixed range will ever be accepted in practice.

Be the foregoing how it may, I do not find the measure to consider ex post results incomprehensible or unreasonable, especially as there is a safe harbor proposed for deviations of less than 20% (see Paragraph 5.5.3.2.4). To the contrary, I believe it would be sensible for taxpayers to include an adjustment clause incorporating the HTVI approach into their CCA contracts at their own initiative. That way there is a legal basis for adjustments on the basis of ex post results, which should offer better chances of a corresponding adjustment in the country of residence of the other participants.

The valuation of current contributions appears to be slightly less complex than the valuation of pre-existing contributions. This is because the value of current contributions depends only on the functions performed by the contributing participant and not on the intangible assets made available by those participants. The valuation exercise even becomes quite straight forward, if it can take place at cost under one of the two exceptions described in Paragraph 5.5.3.1. However, the first exception, which allows the value of the ex-ante commitment of resources to be shifted to the value of a pre-existing contribution, in principle

²⁶⁵ These US rules allow for the IRS to adjust a taxpayer's income in any open taxable year and for all subsequent taxable years for the duration of the CCA activity, if the return on investment (the so-called actually experienced return ratio or AERR) is outside a prefixed range. For more details see Paragraph 4.3.3.3.

²⁶⁶ 2008 Temporary Cost Sharing Regulations, preamble.

²⁶⁷ Wright, Keates, Lewis and Auten, International Transfer Pricing Journal 2016/2.

only defers the complexity to the valuation of the pre-existing contribution. It might offer some actual simplification in case of CCAs that are project based or CCAs that are concluded for a limited period of time. In case of open ended CCAs on the other hand, it can actually be counterproductive, as it can be extremely difficult to determine the lump sum value of such ex ante commitment and then attribute that value to the pre-existing contribution (see Paragraph 4.3.6). The second exception allows for a valuation at cost, if contributions are of a similar nature and the difference between their value and cost is immaterial. However, as already established in Paragraph 5.5.3.1, the application of this exception is effectively restricted to services CCAs. When it comes to current contributions not qualifying for either of the exceptions, a comparable uncontrolled price would have to be sought, a more substantial profit mark-up on costs would have to be applied or a transactional profit split has to be determined.

Finally, in respect of funding contributions, I agree with the OECD that these represent a limited value. After all, if the other participants take care of all other contributions, including the contribution of pre-existing intangibles and the performance of development activities, it is quite unlikely that they would enter into a funding arrangement with a third party allowing that third party to reap returns in excess of a risk adjusted return, especially if they could obtain funding at a fixed interest rate elsewhere.

5.6. Balancing Payments

5.6.1. Introduction

After the contributions are identified and appropriately valued, the next step is to allocate the costs involved among the participants in proportion to their share in the anticipated benefits from the CCA. If it turns out that the contributions of one or more participants are insufficient, then the contributions of one or more other participants will have been excessive. This is to be adjusted through appropriate balancing payments between these participants. It should be noted that the valuation of contributions at market price has the consequence that balancing payments will in most cases come to include a profit element. By consequence, the amount settled can exceed the costs incurred by the participants receiving such payments. The OECD considers these payments to increase the value of the contributions of the payer and decrease that of the payee.²⁶⁸ Although this is not stated in the Transfer Pricing Guidelines, I believe that balancing payments can be spread out over the course of the CCA, but

²⁶⁸ OECD Transfer Pricing Guidelines, Paragraph 8.34.

could also take the form of a lump sum. For purpose of calculating the amount of the payments an appropriate cost allocation method has to be selected (see Paragraph 5.6.2). If the expectations about future benefits of participants change, this could be a reason to prospectively make adjustments to such allocation method (see Paragraph 5.6.3).

5.6.2. Allocation Methods

In order to allocate costs in a way that is consistent with the division of expected benefits, it is necessary to establish the relative value of the interest assigned to each participant. The OECD Transfer Pricing Guidelines do not prescribe a fixed way in which to do this. An obvious approach would be to prepare an upfront estimate of additional income or cost savings per participant as a result of the activities performed under the CCA (a “*direct*” allocation method). However, financial projections may be unreliable. This is generally more likely with benefits that are realized in the further future. As projections themselves become uncertain, it may be practically preferred to instead apply an allocation key based on an objectively verifiable measure that can reasonably be assumed to indicate a participant’s future benefit (an “*indirect*” allocation method). However, such indirect allocations on the basis of a general key can make it more difficult to then evidence such benefit (see Paragraph 5.2.2). Nevertheless, they are explicitly sanctioned by the OECD in Paragraph 8.21 of the Transfer Pricing Guidelines. Possible objectively verifiable measures to use as an allocation key include assets, capital invested, number of employees, production, sales and earnings. If a CCA covers multiple activities, it could also be considered to use more than one allocation key. Allocation keys can be selected because they are closely related to the cost shared activities (I refer to those keys as “*activities-based*” keys) or because they can reasonably be considered indicative for expected benefits (I refer to those keys as “*benefits-based*” keys). For example the number of computer workstations might be an appropriate activities-based allocation key for the costs and risks involved in the development and roll-out of an internally employed software product. On the other hand in strongly trademark driven businesses sales could be expected to be a realistic benefits-based indicator of the expected future benefits per participant from the cost shared development of a new brand name.

Whether an activities-based key or a benefits-based key is more appropriate in my view depends on the scope of the activities covered by the CCA. An activities-based key is more likely to be suitable, if the scope of activities is narrow and the main purpose is to realize a cost saving or develop an asset or service that is intended only for internal use. In that case there will often be a relatively direct

relationship between the activities and the expected benefits and a correspondingly higher reliability of the selected allocation key. If the scope of activities is wide and the main purpose is to create additional income, it may be better to use a benefits-based key. In that case the relationship between the activities and the expected benefits will be more indirect. This can influence the reliability of the allocation key and that makes it even more important to consider all relevant facts and circumstances. For example, units produced or sold is only an appropriate key, when the cost shared activities relate to the production or sale of uniform items under comparable circumstances. If the participants produce or sell different products with variable profit margins, units produced or sold can be a less suitable measure to determine their share in expected benefits. In the same way third party sales will only be a reliably profit indicator, if participants operate at the same level in the value chain, for example if they are all manufacturers and/or they are all distributors. If third party sales are used as an allocation key for participants that operate at different levels in the value chain, manufacturers are likely to be allocated too little and distributors are likely to be allocated too many costs.

5.6.3. Adjustments

If the actual benefits of participants differ substantially from their anticipated results or relevant circumstances change in such a way that the expectations about future benefits are altered, it may be necessary to adjust the cost allocation method. In fact, the OECD Transfer Pricing Guidelines require all CCAs to foresee in a periodic reassessment of contributions vis-à-vis the revised share of benefits.²⁶⁹ The US Cost Sharing Regulations provide for a similar requirement.²⁷⁰ Adjustments to cost allocation methods should be distinguished from adjustments to the value of (pre-existing) contributions. The latter adjustments were discussed in Paragraph 4.3.3.3 and Paragraph 5.5.3.2.4. They may under circumstances have a retroactive effect. Adjustments to cost allocation methods on the other hand are intended to be of a prospective nature only. I believe that adjustments of the allocation method are more likely to occur when a direct allocation method is used, for example when the cost allocation is for a longer period of time based on anticipated results as determined at the outset of the CCA. Contrary to such a fixed direct cost allocation, a variable indirect allocation based on a general allocation key has the advantage that it automatically corrects the cost allocation to better reflect actual results. If for example a sales key is used, this means that balancing payments in the course of the CCA

²⁶⁹ Idem, Paragraph 8.22.

²⁷⁰ 2011 Final Cost Sharing Regulations, Paragraph 1.482-7(e)(1)(i).

will be adjusted to actual sales of the participants in the fiscal year to which the balancing payment relates.

5.6.4. Buy-in, Buy-out and Termination Payments

A change in the constellation of participants in an existing CCA occurs when a new participant joins the arrangement, an existing participant leaves the arrangement or the CCA is terminated. This can effectively result in a transfer among the participants of the effective ownership of the results from the cost shared activities already performed. Such a transfer will require an appropriate arm's length compensation. The OECD recognizes this in section D of Chapter VIII of the Transfer Pricing Guidelines, where it refers to these payments as buy-in and buy-out payments.²⁷¹ That section however does not provide for any specific guidance on how these payments are to be calculated. It only mentions that they should be determined in accordance with the other chapters of the Transfer Pricing Guidelines, most notably Chapter I – III and Chapter VI. Furthermore, it indicates that the tax treatment of buy-in and buy-out payments should be the same as when the payments were made to acquire the interest in the results of the cost shared activities outside of the CCA.

In my opinion when a new participant joins an existing CCA, the relationship between the existing participants and the new participants is similar to that of participants that conclude a completely new CCA. The existing cost shared results constitute assets of a pre-existing value developed externally from that new CCA. They are in other words pre-existing contributions of the original participants, for which the new participant should pay an appropriate balancing payment as outlined in the preceding paragraphs above. When on the other hand a participant leaves the CCA and abandons its interest in the cost shared results in favor of the remaining participants, it in fact transfers such interest to the other participants. In my opinion this logically triggers balancing payments from the remaining participants to the departing participant. As such, Section D of Chapter VIII does not provide completely original guidance, but instead only clarifies how the mechanics of a CCA outlined elsewhere in Chapter VIII work out in case of newly entering or exiting participants.

²⁷¹ OECD Transfer Pricing Guidelines, Paragraph 8.44 and 8.46.

5.7. Conclusions

The key findings of this Chapter 5 are as follows,

In respect of scoping of activities:

- (i) Both development activities and services are suitable for cost sharing, provided they benefit multiple participants. Shareholder activities, duplicative activities and activities resulting only in incidental benefits by definition have to be excluded. The existence of a benefit can be more difficult to evidence when an indirect cost allocation method is used. However, tax administrations should only disallow balancing payments because of duplication in case of clearly abusive situations, because it is highly unlikely that an MNE would otherwise knowingly allow for an inefficient structuring of its operations.

In respect of selection of participants:

- (i) Only group companies that expect a real benefit from their own individual exploitation of the cost shared results can participate in a CCA, i.e. only those group companies that are entitled to some part of the residual profit from the exploitation of those results. Low risk service providers merely expecting a cash compensation for the activities they perform are excluded. As such, participants are those group companies that perform primary activities, generally manufacturing or sales, and the level at which those activities are integrated within the group defines them.
- (ii) Group companies can only participate in a CCA, if they can assume the risks associated with the cost shared activities. It is a logical consequence of the ALS that a party to a transaction cannot assume risks, if it does not have a minimal level of substance. It should employ relevantly skilled personnel and have at its disposal the further necessary resources to control such risks.
- (iii) The control-over-risk requirement limits the level of centralization allowed under a CCA. It therefore targets CCAs that are on the top end of the vertical axis of the categorization model of Paragraph 2.3.3.2. If centralization reaps a group company from the capacity to control any of the risk associated with the cost shared activities, i.e. in the case of a true cash box entity, then such company is disallowed access to the CCA altogether. However, the control-over-risk requirement has not been consistently

applied in international tax law. The US Treasury and IRS for example have traditionally allowed US taxpayers to enter into CSAs with low substance affiliates located in tax havens.

- (iv) If a non-participating group company benefits from the activities performed under a CCA, they should pay an appropriate compensation that should be shared proportionally among the participating group companies. As the non-participant does not become a co-owner of the results from the CCA, such compensation is not necessarily equal to the amount that the non-participant would have been charged had it in fact participated in the CCA.

In respect of assignment of benefits:

- (i) To avoid uncertainty and disputes, the CCA contract should identify benefits and assign them to individual participants as unambiguously as possible. Most commonly benefits are divided up on a territorial or field of use basis. This should be done in such a way that future benefits of each participant can be estimated with reasonable reliability and can be properly administrated when they materialize.

In respect of valuation of contributions:

- (i) Contributions of participants can consist of assets, including intangible assets, obtained or developed externally from the CCA (so called pre-existing contributions) as well as the performance or funding of cost shared activities (so called current contributions).
- (ii) “Soft” intangibles like local market features, a work force in place, goodwill and going concern value are not contributions themselves. They can however qualify as comparability factors that impact the valuation of contributions.
- (iii) It follows from the ALS that contributions under a CCA should be valued at market price and not at cost. More strictly testing this will ensure that all resources made available under CCAs aimed at developing high value, innovative intangibles are appropriately rewarded. As such, that targets CCAs that are at the right end of the horizontal axis of the categorization chart of Paragraph 2.3.3.2. The valuation of contributions under these arrangements should reflect the arm’s length value of all functions performed, assets used and risks assumed.

- (iv) The OECD Transfer Pricing Guidelines allows for two exceptions to the main rule that current contributions should be valued at market price. As the value of the contributions of a participant should be tested against market price on an accumulated basis, current contributions may be valued at cost, if the effect of comparability factors is already reflected in the valuation of earlier pre-existing contributions. Furthermore, a valuation at cost can be an appropriate way to determine the relative value of current contributions under low value added services CCAs.
- (v) The first exception, leaving room to reflect the effect of comparability factors related to later current contribution in the valuation of earlier pre-existing contributions, was undoubtedly instigated by the United States. The US Treasury and IRS have since long been seeking to increase buy-in payments to US based group companies. There are clear downsides to this approach, specifically when it comes to open-ended CCAs. These downsides are caused by an irregularity, which consists of taking into account comparability factors for purposes of a valuation exercise that are inherently related to contributions that are the subject of another, completely separate valuation exercise. Firstly, this significantly overcomplicates the valuation of the pre-existing contributions. Secondly, it shifts the focus of discussion about current contributions to the cost basis, which leads to difficult to answer questions about which costs have to be shared. Thirdly, it implies a timing mismatch as it involves a front loading of taxable income to a time at which the pre-existing contribution is compensated, while the value is created only when the later cost shared activities are performed.
- (vi) By their nature, transfer pricing analysis of CCAs will frequently involve the valuation of intangible assets. There is not a single valuation technique that mandatorily has to be applied for all these valuations, nor is there any valuation standard or method that should be rejected upfront. It will often be most appropriate to value an intangible at the discounted value of projected future income or cash flows.
- (vii) If there is no reliable comparable and future income from the exploitation of intangibles is difficult to predict, the OECD under certain conditions sanctions the use of ex post results for purposes of testing the arm's length nature of a valuation. I believe that taxpayers should consider adopting a price adjustment clause in their CCA contracts in anticipation of this.

In respect of the calculation of balancing payments:

- (i) Disproportionality of contributions is to be restored through so called balancing payments. As a consequence of the valuation of contributions at market price these payments will in most cases include a profit element. The amounts that are to be settled can be determined using either a direct or an indirect cost allocation method. An indirect cost allocation method can feature an activities-based or a benefits-based key. The former is more suitable in case of a narrowly scoped CCA aimed at realizing a cost saving, while the latter is more suitable in case of a broadly scoped CCA aimed at generating additional income.
- (ii) The allocation methods may require prospective adjustments, if they no longer reflect the participants' proportionate share of anticipated benefits.
- (iii) If new participants enter or existing participant leave a CCA, that will often lead to a transfer of the intangibles already developed under the CCA prior to such event. Those intangibles should then be regarded a pre-existing contribution of the existing participants or the departing participant. In either case, after a market price valuation of the intangibles such contribution should be appropriately compensated for by the incoming or departing participants.

6. European Union

6.1. Introduction

While the OECD and US have clearly dominated the debate about transfer pricing aspects of CCAs, the arrangements have also for several years been on the work program of the EU Joint Transfer Pricing Forum (“EUJTPF”). As a concrete result from that a Report on services CCAs not creating intangible property was published on 7 June 2012.²⁷² This Report was intended to supplement the EUJTPF’s guidance on low value adding intra-group services and to complete its work on intra-group services in general. In order not to interfere with the ongoing OECD project on the transfer pricing aspects of intangibles, the scope of the Report was deliberately limited to those CCAs that do not create intangible property. The conclusions in the Report received full support from the European Commission in its “*Communication on the Work of the EUJTPF in the period July 2010 to June 2012*”.²⁷³ That Communication was adopted by the Commission on 19 September 2012 and subsequently welcomed by the European Council on 4 December 2012.²⁷⁴ This Chapter 6 analyzes that Report and puts it in a critical perspective. It is an adjusted version of an article, which I published in the International Transfer Pricing Journal in April 2013.²⁷⁵

6.2. Legal Status of the EUJTPF Report

First of all it is important to note that binding European harmonization in respect of direct taxes is generally only possible through Council directives. These require unanimous consent of all Member States. For situations in which unanimity is not achieved but at least nine Member States do want to proceed,

272 European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period July 2010 to June 2012 and related proposals 1. Report on Small and Medium Enterprises and Transfer Pricing and 2. Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP), 19 September 2012, COM(2012)516.

273 Idem.

274 European Council, Press Release 17131/1/12 REV 1, 4 December 2012.

275 Nijssen, International Transfer Pricing Journal, 2013/3.

the Treaty of Nice introduced the possibility of “*enhanced cooperation*”. This allows for increased integration in an area within EU structures, without all Member States being involved. However, it is still a cumbersome and politically complicated process. As an alternative the European Commission often takes the initiative itself to position harmonization measures as mere recommendations. That is also the case in respect of the proposals included in the EUJTPF Report, which the Commission has invited Member States to implement in their national legislation or administrative rules.²⁷⁶ Although such invitation might put some pressure on Member States to adopt the recommendations, it still does not cause the EUJTPF Report to exceed the status of “*soft law*”.

6.3. Contents of the EUJTPF Report

6.3.1. Activities and Participants

After an introductory section the Report starts off to clarify the difference between the definition of intra-group services (“*IGS*”) on the one hand and CCAs on the other. The OECD Transfer Pricing Guidelines make the same distinction, addressing IGS in chapter VII and CCAs in chapter VIII. At the time the EUJTPF wrote its Report, the OECD Transfer Pricing Guidelines defined a CCA as “*a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights*”.²⁷⁷ The Report duplicated this definition²⁷⁸ and continued to list the distinctive elements of CCAs as compared to IGS²⁷⁹. Among others it is stipulated that CCAs are aimed at not only sharing costs, but also risks and benefits of the activities covered. As such, the EUJTPF recognizes that under a CCA all participants also share in the costs of unsuccessfully or inefficiently provided services, whereas under IGS the service provider generally bears the risk of failed or over expensive projects.

Furthermore, like the OECD Transfer Pricing Guidelines and the US Cost Sharing Regulations before it, the EUJTPF Report confirms that a CCA allocates costs and risks based on the expected benefits of participants, while in case of IGS the allocation is determined by the extent to which service recipients request services to be rendered. As a result a company cannot be a participant in a CCA,

²⁷⁶ COM/2012/516, section 3: Commission Conclusions.

²⁷⁷ OECD Transfer Pricing Guidelines, paragraph 8.3 (old).

²⁷⁸ EUJTPF, “*Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP)*”, Paragraph 7.

²⁷⁹ Idem, Paragraph 12.

if the only benefit it expects consists of receiving a payment for the CCA activities it performs. Instead such company would be regarded an IGS provider, that should include a profit element in its service fee.²⁸⁰ While the EUJTPF's position on the requirement of an expected benefit for each participant is very clear, its position is more ambiguous where it concerns the minimum level of influence on decision making required per participant in respect of the services covered by a CCA. Under the Report participants can contribute either in cash or in kind and it is therefore not necessary for them to actively participate in the actual performance of these services. In respect of substance requirements applying to participants, the Report goes no further than to state that their involvement in cost shared activities can vary depending on the type of CCA, the expertise of the participants and the amount of costs being allocated to the respective participants.²⁸¹ Initially it was considered to include that each participant has to be involved in strategic decision making, but not necessarily in the day to day management. However, that wording was left out on request of the Dutch representatives at the EUJTPF and private sector members, because it was not regarded relevant in respect of the services covered by the Report.²⁸² As a consequence the minimum influence on decision making depends on facts and circumstances, which have to be assessed on a case by case basis. The EUJTPF Report therefore leaves open the possibility that CCAs may exist under which certain participants with limited substance have no such influence at all. In my opinion this overly careful approach hollows out the Report and thereby further reduces its added value. Be that how it may, since the OECD's renewed guidance has meanwhile introduced a requirement for participants to control the risks associated with the cost shared activities²⁸³, it should be assumed that also in respect of services CCAs concluded in the EU minimum standards apply for the substance of participating group companies.

6.3.2. Benefits and Contributions

As the EUJTPF operates within the framework of the OECD Transfer Pricing Guidelines, it makes sense that the Report requires the outcome of CCAs to be in line with the ALS. This implies that third parties should under similar circumstances also have been prepared to enter into the CCA. As such each participant's expected benefit should be consistent with the value of its overall contri-

²⁸⁰ Idem, Paragraph 43.

²⁸¹ Idem, Paragraph 16, sub (viii).

²⁸² Revised Secretariat working document, March 8th 2012, JTPF/020/REV2/2011.

²⁸³ See Paragraph 5.3.2.2.

bution. The EUJTPF Report provides some guidance in respect of both these elements.

In respect of expected benefits, the Report points out that those can consist of an increase of income, a saving in expenses, the possibility to maintain profit or the avoidance of losses.²⁸⁴ As already stated in the OECD's Transfer Pricing Guidelines a key element is that the participants should have been prepared to pay for the services or otherwise would have performed the services themselves. For activities not creating intangible property it is often possible to determine the benefit of individual participants by applying an appropriate allocation key to the group's overall benefit. The EUJTPF's earlier Guidelines on low value adding intra-group services already provided allocation keys of common usage.²⁸⁵ All in all the Report does not seem to add much to the existing guidance from other sources in respect of the benefit test. On the contrary, it could create some confusion by what appears to be a *circulus in probando* where it is included in Paragraph 30 that the allocation key chosen should reflect the expected benefit per participant, while Paragraph 31 states that it should be able to derive the benefit per participant from applying an appropriate allocation key.

When it comes to contributions the Report, like the OECD Transfer Pricing Guidelines before it, explains how these can be valued at market price or at cost. At the time the EUJTPF Report was written, the OECD did not mandatorily prescribe either method. Instead it only recognized that in this respect further guidance in addition to Chapter VIII of the Transfer Pricing Guidelines might still be required.²⁸⁶ Limiting the Report to CCAs not creating intangible property offered the EUJTPF the opportunity to take an additional step and recommend contributions generally to be valued at cost.²⁸⁷ This is a practical approach, following the assumption that for the type of activities covered by these CCAs there is in most cases only a small difference between the pricing at cost and at market value. That also fits in with the later guidance of the OECD under the BEPS-project, which conditionally allows for a valuation of contributions at cost:

"Whereas it cannot be assumed that the value of pre-existing contributions corresponds to costs, it is sometimes the case that cost could be used as a

²⁸⁴ EUJTPF, "Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP)", Paragraph 29.

²⁸⁵ EUJTPF, "Guidelines on low value adding Intra-group Services" as adopted by the European Commission on January 25th 2011, Paragraph 53.

²⁸⁶ OECD Transfer Pricing Guidelines, Paragraph 8.1.

²⁸⁷ EUJTPF, "Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP)", Paragraph 34.

practical means to measure relative value of current contributions. Where the difference between the value and costs is relatively insignificant, for practical reasons, current contributions of a similar nature may be measured at cost in such cases for services CCAs."²⁸⁸

The next question is of course what costs should be taken into account. Since the Xilinx and Altera case the relevance of that matter has been well recognized in the United States.²⁸⁹ The US 2011 Final Cost Sharing Regulations include more detailed wording on the topic. The EUJTPF's Report on the other hand addresses it in generic terms only:

*"Contributions should include all relevant costs for the acquisition, maintenance or for securing the benefits derived from the arrangement".*²⁹⁰

6.3.3. Balancing Payments and Adjustments

Like the US Cost Sharing Regulations and the OECD Transfer Pricing Guidelines, the Report generally assumes that any inequality of contributions will be compensated through balancing payments. After these payments, the results from the cost shared activities should be commonly available to all participants free of any further charge. As a consequence it makes sense that when a new participant joins, it has to pay an arm's length buy-in premium for IP previously developed under the CCA. Similarly, a buy-out premium can become payable when a participant exits the CCA. By limiting the scope of the Report to CCAs on services not creating IP, the EUJTPF was able to minimize the section on participants joining and leaving a CCA. It does state that an adjustment of the proportionate share of costs to be borne by each participant might be required in such a case to ensure that the remaining arrangement is consistent with the ALS.²⁹¹ However, the complicated matter of how buy-in and buy-out premiums are to be treated, just like the question how contributed pre-existing intangibles are to be valued, is avoided completely.

According to the EUJTPF, tax administrations should not challenge the business choice of entering into a CCA or require an analysis from taxpayers defending such choice.²⁹² At the same time the terms and conditions of the CCA have to be at arm's length, i.e. businesslike. Furthermore, the taxpayer has to be able

²⁸⁸ OECD Transfer Pricing Guidelines, Paragraph 8.28.

²⁸⁹ See Paragraph 4.4.

²⁹⁰ EUJTPF, "Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP)", Paragraph 37.

²⁹¹ Idem, Paragraph 46.

²⁹² Idem, Paragraph 16.

to explain the CCA within the overall context of its business in order to understand the rationale for entering into it.²⁹³ If these requirements are not met, the outcome of the CCA is not consistent with the ALS and a tax administration can under certain circumstances make adjustments to a taxpayer's taxable income. If the actual benefits of participants differ from the expected benefits, the Report instructs tax auditors to first analyze the reasons for the difference before concluding whether the CCA is at arm's length.²⁹⁴ To the extent that projections can be regarded reasonable or the difference is not material, tax administrations should refrain from making adjustments. When testing the projections a tax auditor should not make improper use of hindsight. Instead the economic and commercial circumstances prevailing or reasonably foreseeable at the time of entering into the arrangement should be leading. The question has to be answered whether third parties under similar conditions would have also entered into the arrangement, would have negotiated the possibility to amend the agreement based on results or would not have signed up for it at all. Neither the Report itself nor the EUJTPF's earlier Guidelines on low value adding Intra-Group Services clearly indicates how in respect of the pricing of these services the burden of proof is split up between the taxpayer and the tax administration. This is left to the national law of the Member States. A further analysis of the division of the burden of proof in transfer pricing disputes as well as the documentation requirements in respect of CCAs will follow in Chapter 7.

6.4. Relevance of the EUJTPF Report

In the second to last paragraph of the Report the EUJTPF concludes that: *"following the recommendations [included in the Report] would facilitate evaluation and acceptance that the arm's length principle has been applied in the majority of the cases that fall within the scope of this Report"*²⁹⁵. When adopting the Report, the European Commission was of the opinion that the Report addressed the EUJTPF's key target of achieving a more uniform application of transfer pricing rules within the EU, while the European Council predicted that the Report would *"contribute to reducing tax disputes related to intra-group services within the EU and help improve the functioning of the internal market"*.²⁹⁶ However, by limiting the scope of the Report to CCAs on services not creating intangible property one of the most complex aspects of CCAs, the issue of appraising valuable development activities was circumvented and the matter of entry and exit fees

²⁹³ Idem, Paragraph 25.

²⁹⁴ Idem, Paragraph 17.

²⁹⁵ Idem, Paragraph 55.

²⁹⁶ European Council, Press Release 17131/1/12 REV 1, 4 December 2012.

did not get addressed in much detail. Instead only general wording was included on the valuation of work in progress as well as the rebalancing of cost shares in line with the ALS in case of changes in the group of participants. Although not having to tackle this issue might have speeded up the publication of the Report, it has also undeniably limited its added value.

6.5. Conclusions

The key findings of this Chapter 6 are as follows,

In respect of the intentions and results of the EUJTPF Report:

- (i) With its 2012 Report the EUJTPF has attempted to make recommendations that contribute to a harmonization of the tax treatment of CCAs not creating intangible property within the EU. Useful, though not always innovative guidance is provided on who can participate in a CCA, how expected benefits and contributions per participant are to be valued and what documentation requirements taxpayers have to be lived up to. Furthermore the Report elaborates on the conditions under which tax administrations can adjust a CCA's outcome.
- (ii) Most notably the Report allows for contributions under services CCAs to be valued at cost. By doing so it appears to have created the basis for the later guidance of a similar tenor included in Chapter VIII of the Transfer Pricing Guidelines as part of the BEPS revisions.

In respect of the limitations of the EUJTPF Report:

- (i) The overall level of detail of the Report is limited. The Report does not address the level of influence on decision making required from participants and the identification of costs to be shared under a CCA. Furthermore, by limiting the scope of the Report to CCAs on services not creating intangible property issues around the valuation of development activities and buy-in payments did not get to be exhaustively addressed.
- (ii) As the most pressing issues in respect of the transfer pricing treatment of CCAs are bypassed in the Report, its relevance for day-to-day fiscal practice is limited, most certainly when compared to the OECD Transfer Pricing Guidelines or the US Cost Sharing Regulations.

7. Documentation Requirements

7.1. Introduction

Regardless of whether an MNE's tax strategy is to minimize its tax bill by all legal means, including aggressive tax planning, or just to manage its fiscal position in a responsible manner and avoid uncertainty and risks where possible, the enterprise will be looking for an international cost reallocation mechanism that is practically enforceable and does not place a disproportionate administrative work load on its accounting and control departments. In this context it has to be kept in mind that management reporting does not necessarily require reallocating costs to individual group companies. Instead it can also be acceptable to keep certain costs in a reporting unit maintained by a central legal entity. In that case it is only for fiscal and statutory reporting purposes that costs have to be accurately allocated and invoiced. An MNE focused on its business operations will then naturally seek the most pragmatic solution to such an administrative challenge. Taking that into consideration this Chapter 7 considers the administrative burden that transfer pricing in general and the operation of a CCA in specific may impose on an organization. It starts off to examine the division of the burden of proof between taxpayers and tax authorities in general (Paragraph 7.2) and then discusses documentation requirements in respect of CCAs (Paragraph 7.3, 7.4 and 7.5). Finally, the obligation on tax administrations, to observe reasonableness and proportionality when imposing additional administrative obligations, is discussed and illustrated by an Italian court case from 2005 (Paragraph 7.6).

7.2. Burden of Proof

7.2.1. Who Should Prove What in Tax and Transfer Pricing Cases?

Given their complexity and frequent use in tax planning structures, the tax and transfer pricing treatment of CCAs may relatively often become the subject of dispute between tax administrations and taxpayers. It is then a principle

question who bears the burden of proof in respect of the facts and circumstances determining the taxpayer's legal position. Many countries have in their domestic tax laws split the burden of proof so that tax administrations have to prove taxable income, while the taxpayers have to prove deductible expenses. Some did so because they consider that the burden of proof should rest on the party who can most easily obtain relevant information, others because they uphold that obligations to evidence claims in legal proceedings rest with the party that lays charges. Following this principle other countries, including the United States, take a different approach. In the US taxpayers are considered to have better knowledge of both income and expenses and therefore they are required to evidence all relevant facts in respect of both elements.²⁹⁷ In a European context the division of the burden of proof between tax administration and taxpayer in a transfer pricing case has been the subject of litigation. The European Court of Justice considered that an anti-abuse measure that shifts the burden of proof to the taxpayers in transfer pricing cases can be justified in an EU context by the objective of providing tax avoidance in combination with the objective to preserve the balanced allocation of the power to impose taxes between Member States.²⁹⁸

In an international context it can be particularly difficult for tax administrations to collect all relevant information determining the fiscal position of taxpayers. This is even more so, when cross-border transactions with companies in tax havens are involved and the local authorities are reluctant to exchange information. Many European countries have responded to this by increasing the burden of proof on taxpayers in those instances. The Netherlands for example reverses the burden of proof to the disadvantage of the taxpayer, if the taxpayer does not provide the tax administration with information that rests with a related company in a country with which the Netherlands has not concluded an agreement on the exchange of information.²⁹⁹

Furthermore, the division of the burden of proof takes a special position in transfer pricing cases. From my perspective there are two reasons for this. The first reason follows from the principle based approach (as opposed to a rule based approach) that is inherent to the ALS. The standard's application is always circumstantial and, as also seen in the previous chapters, often requires calculations to be made on the basis of assumptions. Besides the fact that the reliability of these assumptions may be difficult to test, the ALS consistently leaves room for a certain amount of subjective interpretation. There can always

297 B. Leidhammar in Meussen et al 2013, page 3.

298 ECJ C-311/08, "SGI", 21 January 2010. Also see: G.T.K. Meussen, European Taxation 2010/6.

299 Article 47a Dutch General Tax Act ("*Algemene wet inzake rijksbelastingen*").

be different views about what is appropriate and what is fair. In fact multiple transfer pricing methods might lead to different, yet both acceptable outcomes. As a consequence, most of the time it is not possible and also not necessary to evidence indisputably that the one and only correct transfer price has been determined. Instead, it is sufficient to show that in good faith a pricing method was used that has led to an acceptable outcome.³⁰⁰ It is probably less complicated to defend that this is the case than to prove the opposite. The second reason why the burden of proof requires extra attention in transfer pricing cases is that tax administrations, as mentioned several times before already, have a natural information disadvantage compared to taxpayers. The latter have more direct insight in their business and the market on which they operate. Taxpayers are in the best position to establish where, how and by whom functions are performed, assets are used and risks are assumed within their company and what is therefore an appropriate transfer pricing policy. Tax administrations on the other hand have a much harder job evidencing the negative, i.e. that transfer prices used are non-businesslike and would not have been agreed upon by third parties under similar conditions.

The foregoing makes the division of the burden of proof between tax administrations and taxpayers a delicate matter deserving careful attention. The OECD has worded its concerns about that as follows:

*"In practice neither countries nor taxpayers should misuse the burden of proof... Because of the difficulties with transfer pricing analysis, it would be appropriate for both taxpayers and tax administrations to take special care and to use restraint in relying on the burden of proof in the course of the examinations of a transfer pricing case. More particularly, as a matter of good practice, the burden of proof should not be misused by the tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing. A tax administration should be prepared to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle even where the burden of proof is on the taxpayer, and taxpayers similarly should be prepared to make a good faith showing that their transfer pricing is consistent with the arm's length principle regardless of where the burden of proof lies."*³⁰¹

300 In line with this concept Paragraph 5.27 of the OECD's Transfer Pricing Guidelines requires taxpayers "to endeavor to determine transfer prices for tax purposes in accordance with the arm's length principle".

301 OECD Transfer Pricing Guidelines, Paragraph 4.16.

If tax administrations want to adjust a taxpayer's taxable income in a transfer pricing conflict, it is in most countries up to them to show that the outcome of intra-group transactions is not in line with the ALS. There are also some countries, including the United States, where the burden of proof is with the taxpayer from the start. However, corrections made by a tax administration in these countries should always be in accordance with transfer pricing standards as derived from tax law and in the US for example corrections cannot be upheld, if the taxpayer is able to show that a transfer price adjustment is arbitrary or capricious.³⁰² Be this how it may, it is commonly accepted, also outside the US, that the information inequality places tax administrations at a serious disadvantage. Legislators have tried to compensate for this by including an obligation for taxpayers in their tax laws to adhere to any reasonable information request from tax administrations. This is often supplemented by requirements for taxpayers to document both how transfer pricing methods were selected and how it is ensured that they have an arm's length outcome. As Marino worded it in his contribution to the EATPL's 2011 Report on the burden of proof in tax law:

*"...due to the aforementioned globalization trend, tax administrations are becoming more and more unable to collect the necessary information in order to better ascertain the international tax allocation, and this is the reason why there is a parallel trend to somehow shift this burden to taxpayers by requiring the collection of a set of documents related to their international transfer pricing policy."*³⁰³

The "parallel trend" referenced by Marino received a further push, when the concern of the general public about tax avoidance resulted in a demand for increased transparency on the tax strategies of MNEs and the OECD included in the BEPS Action Plan an action to re-examine transfer pricing documentation.³⁰⁴ That resulted in a Final Report outlining a standard set of documentation that should provide tax administrations with all relevant information about global allocation of income, economic activity and tax paid, the contents of which is further discussed in Paragraph 7.3.³⁰⁵

302 See for an analysis of the burden of proof in transfer pricing matters under US tax law: J. Witten-dorff 2010, Paragraph 2.3.3.2.2.

303 See G. Marino in Meussen et al 2013, page 40.

304 OECD, "Action Plan on Base Erosion and Profit Shifting", 19 July 2013, Action 13.

305 OECD/G20, "Transfer Pricing Documentation and Country-by-Country Reporting", 5 October 2015.

7.2.2. Penalties

As explained above most countries use documentation requirements to shift the burden of proof on to the taxpayer. By consequence, the taxpayer is incentivized to meet these requirements and to, by doing so, reverse that shift. However, many tax administrations did not solely want to rely on the allocation of the burden of proof to enforce documentation requirements. They have additionally imposed penalties in case of non-compliance. These penalties usually consist of one fixed amount or fixed amounts per missing document. In more exceptional cases they might also be defined as a percentage of the tax understatement, a percentage of the income adjustment or a percentage of the value of undocumented transactions. Alternatively countries promote the fulfillment of documentation requirements by granting penalty protection to compliant taxpayers. These countries limit the penalty levied on tax adjustments, provided the taxpayer completed the required documentation in good faith and submitted it timely to the proper authorities.

7.3. OECD Documentation Guidance

7.3.1. The Three-Tiered Approach

The purpose of transfer pricing documentation is generally threefold. It forces taxpayers to establish consistent transfer pricing policies, it enables tax administrations to perform transfer pricing risk assessments and it facilitates tax audits.³⁰⁶ In order to achieve these objectives the OECD, as part of the BEPS-project, adopted a three-tiered approach based on the EU's transfer pricing documentation concept, which is discussed in Paragraph 7.5. This approach requires MNEs to prepare a central master file supplemented by local files and a so called country-by-country report. The master file should provide a "*blue-print*" of the MNE's group, describing its organizational structure, its business activities, its use of intangibles, intercompany financial transactions as well as its financial and tax positions.³⁰⁷ As the master file can be used in different countries, it should allow MNEs an efficient way to meet their documentation requirements. It is acknowledged that the master file is intended to provide only a high-level overview of the MNE's operations and policies. Not all elements have to be addressed in detail. Nevertheless, the master file should at least list important agreements, intangibles and transactions. As such reference to CCAs

³⁰⁶ OECD Transfer Pricing Guidelines, Paragraph 5.5.

³⁰⁷ OECD Transfer Pricing Guidelines, Chapter V, Section C.1.

in place within the group are a first requirement. Furthermore, it should become clear from the master file what type of intangible property the company uses and what role it plays in its value chain. Together with the information on the company's organizational set-up, the master file should then allow its reader to position the MNE's CCA under the categorization chart of Paragraph 2.3.3.2. In fact, I would promote MNEs to proactively include specific wording explicating that position and how that impacted the terms and conditions of the CCA, including most notably the selection of participants and the valuation of contributions.

The local files should provide more detailed information about intercompany transactions in which the individual group companies are involved.³⁰⁸ This may concern relevant financial information, a comparability analysis and the selection of the most appropriate transfer pricing method. In respect of CCAs the local file could include the value of contributions made by individual group companies as well as the calculation of balancing payments made or received by these companies. Together with the master file and the other relevant documentation, such as intercompany agreement, intercompany invoices, benchmark studies, documentation prepared for management purposes etc., the local files should assist tax administrations to better understand the activities performed, the participants, the division of benefits, the value of contributions and the allocation of costs and risks.

The OECD's three-tiered approach is completed by the so called country-by-country report. In this report MNEs have to show on an aggregated basis per tax jurisdiction their income and profit, income tax paid, stated capital and accumulated earnings, number of employees and book value of their tangible assets.³⁰⁹ The Transfer Pricing Guidelines mention specifically that *"the information in the country-by-country report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a fully functional analysis and a full comparability analysis"*. This information is intended to offer tax administrations a starting point for a transfer pricing risk assessment and tax audits. In respect of CCAs the stated capital and accumulated earnings, number of employees and book value of assets are relevant elements determining the level of substance and therefore the ability of MNE affiliates to exercise control over risk and thus be actively involved in cost shared activities. Furthermore, the reported income and profit per jurisdiction might be an indication of whether the anticipated benefits of participants, on the basis of which costs and risks were allocated, were determined in a reasonable manner. The OECD assumes

³⁰⁸ Idem, Section C.2.

³⁰⁹ Idem, Section C.3.

that the transfer pricing documentation package will be updated every year. It is preferred to require the update of the master file to be completed on the due date for filing the tax return of the group's ultimate parent company. The update of local files is to be completed at the due date for filing the local tax return and the updated country-by-country report should be available no later than one year after the last day of the fiscal year of the ultimate parent.³¹⁰ Since the OECD's proposal many OECD Member States have implemented a Country-by-country reporting requirement into their national law, while the European Council on 25 May 2016 adopted a directive for a mandatory country-by-country reporting by all MNEs, headquartered in the EU or outside, that have business activities on the European market and have a global turnover of more than € 750 million.³¹¹

7.3.2. The CCA Contract

The extent in which information about an individual CCA is to be included in the master file or local files depends on its complexity and importance. However that may be, details should always be accessible to all participants and it can be expected that they are outlined in a CCA contract. Taxpayers should be prepared to provide this contract to tax administrations upon their reasonable request. It should be available and signed by all participants at the outset, i.e. before the joint activities commence. The most relevant information that this contract should include according to the OECD is listed in the Transfer Pricing Guidelines. In respect of the initial terms of the CCA it concerns:

- A list of participants;
- A list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;
- The scope of the activities and specific projects covered by the CCA, and how the CCA activities are managed and controlled;
- The duration of the arrangement;

³¹⁰ Idem, Paragraph 5.29 – 5.30.

³¹¹ European Council, Directive (EU) 2016/881 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, 25 May 2016, OJ L146/8.

- The manner in which participant's proportionate shares of expected benefits are measured, and any projections used in this determination;
- The manner in which any future benefits (such as intangibles) are expected to be exploited;
- The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined (including any budgeted versus actual adjustments) and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions;
- The anticipated allocation of responsibilities and tasks, and the mechanisms for managing and controlling those responsibilities and tasks, in particular, those relating to the development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets used in the CCA activity;
- The procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA; and
- Any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.³¹²

When it comes to information that might be useful over the duration of the CCA the above is complemented by documentation outlining:

- Any change to the arrangement (e.g. in terms, participants, subject activity), and the consequences of such change;
- A comparison between projections used to determine expected benefits from the CCA activity with the actual share of benefits;
- The annual expenditure incurred in conducting the CCA activity;
- The form and value of each participant's contribution made during the CCA's term; and

³¹² Idem, Paragraph 8.52.

- A detailed description of how the value of contributions is determined.³¹³

7.4. PATA Documentation Guidance

United in the Pacific Association of Tax Administrations (“PATA”) the tax authorities of Australia, Canada, Japan and the United States have published the so called PATA Documentation Package (“PDP”).³¹⁴ Using the PDP eliminates the need to prepare separate documentation for each country. It is voluntary and does not increase the legal requirements imposed on taxpayers in local laws. If a taxpayer satisfies the PDP’s operative principles it is guaranteed to have fulfilled the transfer pricing documentation requirements in each PATA country. PATA tax authorities will then not impose transfer pricing penalties in respect of the documented transactions. On the other hand complying with the PDP does not guarantee that documented transactions are at arm’s length. Therefore it does not rule out transfer pricing adjustments or the assessment of interest on those adjustments.

The PTP is based on three operative principles:

- (i) The taxpayer needs to make reasonable efforts to establish that transfer prices are at arm’s length,
- (ii) The taxpayer needs to maintain contemporaneous documentation of the efforts to comply with the ALS, and
- (iii) Upon request the taxpayer needs to produce the documentation to the PATA tax authorities in a timely manner.

What qualifies as reasonable efforts to establish at arm’s length transfer prices is left to the discretion of the individual PATA tax authorities. It generally includes the analysis of controlled transactions, an investigation into possible comparables as well as the selection and application of an appropriate transfer pricing method.

The second operative principle requires contemporaneous documentation. Contemporaneous in the sense of the PDP means that it should exist on the due date for filing the income tax return for the period in which the controlled transactions took place. The further requirements for the documentation are outlined in a schedule added as an annex to the PDP. In respect of CCAs the

³¹³ Idem, Paragraph 8.53.

³¹⁴ PATA Transfer Pricing Documentation Package, 12 March 2003, IR-2003-32.

information to be available is quite similar to that identified by the OECD. The PATA lists the following:

- A copy of the CCA agreement that is contemporaneous with its formation (and any revision) and any other agreements relating to the application of the CCA between the participants;
- A list of participants and other associated enterprises that will benefit from the CCA;
- The extent of the use of CCA property by associated enterprises which are not CCA participants, including the amounts of consideration paid or payable by these non-participants for use of the CCA property;
- A description of the scope of the activities to be undertaken, including any intangible or class of intangibles in existence or intended to be developed;
- A description of each participant's interest in the results of the CCA activities;
- The duration of the arrangement;
- Procedures for and consequences of a participant entering or withdrawing from the agreement (i.e., buy-in and buy-out payments) and for the modification or termination of the agreement;
- The total amount of contributions incurred pursuant to the arrangement;
- The contributions borne by each participant and the form and value of each participant's initial contributions (including research) with a description of how the value of initial and ongoing contributions is determined and how accounting principles are applied;
- A description of the method used to determine each participant's share of the contributions including projections used to estimate benefits, any rationale and assumptions underlying the projections, and an explanation of why that method was selected;

- The consistent accounting method used to determine the contributions and benefits (including the method used to translate foreign currencies), and to the extent that the method materially differs from accounting principles accepted in the relevant PATA member's country, an explanation of the material differences;
- Identification of each participant's expected benefits to be derived from the CCA, the extent of the benefits expected, and the formula and projections used for allocating or sharing the expected benefits, and the rationale and assumptions underlying the expected benefits;
- Where material differences arise between projected benefits and actual benefits realized, the assumptions made to project future benefits need to be amended for future years, and the revised assumptions documented;
- Procedures governing balancing payments, e.g. where payments are required to reflect differences between projected benefits and actual benefits realized.

7.5. EU Documentation Guidance

The OECD's multi-tiered approach discussed above is based on a concept for transfer pricing documentation that was first introduced by the European Union. It was presented as the "*Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union*" ("*EUTPD*"), which was proposed by the European Commission on 10 November 2005 and adopted by the European Council on 27 June 2006.³¹⁵ The EUTPD requires MNEs with business operations in the an EU Member State to prepare a master file and a file with country-specific information. The latter file is similar to the local file required under the OECD Transfer Pricing Guidelines since the BEPS-project. The EUTPD is "*soft*" law. As such it is not binding on the EU Member States, although it does pose political pressure on them to implement its provisions under their national law as much as possible. Generally Member States have done so in different ways and that has put some limitation on the harmonization actually achieved. At the same time it has to be recognized that Member States generally refrain from imposing penalties if transfer pricing documentation is prepared in line with the EUTPD, that they accept transfer pricing documentation to be prepared in

³¹⁵ European Council, Resolution on a code of conduct on transfer pricing documentation for associated enterprises in the EU, 28 July 2006, OJ C176/1 ("*EUTPD*").

English, provided it is translated upon request, and they allow for the use of pan-European comparables to evidence uncontrolled prices.³¹⁶

The Code of Conduct on EU Transfer Pricing Documentation did not cover any specific guidance on the documentation of CCAs. This blind spot was later filled in by the EUJTPF's "*Report on Cost Contribution Arrangements on Services not Creating Intangible Property (IP)*".³¹⁷ That Report provides a list of corroborative information on CCAs that a taxpayer should be able to make available to a tax auditor upon request. This list covers information about the general set-up of the CCA, its participants, the valuation of their expected benefits as well as the measurement of their contributions. Furthermore, the list includes documentation on the monitoring of the CCA's outcome and the relationship with non-participants, who might provide or receive CCA services.³¹⁸ Taxpayers seem to be granted some flexibility when it concerns the format in which they may submit the information. The Report equally values information from for example written agreements, a narrative and data from computer systems.³¹⁹ However, all in all the paragraphs on documentation requirements are not groundbreaking. Nevertheless, they do supplement the EUJTPF's earlier work and the pragmatic approach in respect of formats might indeed help to restrict the administrative burden on taxpayers.

7.6. Proportionality

An effective way to limit the administrative burden appears to be international harmonization of documentation requirements.³²⁰ The initiatives by the EU, PATA and OECD show that both tax administrations and intergovernmental organizations recognize this. In fact, they commonly accept that transfer pricing documentation rules should strike a balance between having useful information provided to tax administrations and limiting the administrative burden placed on taxpayers. As such, I would argue that a proportionality principle applies. Confirmation of such principle can also be found in Paragraph 5.28 of Chapter V of the Transfer Pricing Guidelines as revised under the BEPS project:

³¹⁶ For a comparative analysis see Guðmundsson, *International Transfer Pricing Journal* 2009/1.

³¹⁷ European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period July 2010 to June 2012 and related proposals 1. Report on Small and Medium Enterprises and Transfer Pricing and 2. Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP), 19 September 2012, COM(2012)516.

³¹⁸ EUJTPF, "*Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP)*", Paragraph 25.

³¹⁹ *Idem*, Paragraph 51.

³²⁰ Also compare Borkowski, *International Tax Journal*, 2003/2.

"Taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation. Therefore tax administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer of creating it..."

The overall level of detail required in transfer pricing documentation should reflect this. It can, for example, be regarded unnecessary and overly cumbersome to require MNEs to list all individual intra-group transactions, while it may be appropriate to require them to show transaction flows, invoice flows and amount of transaction flows on an aggregated basis. At the end of the day transfer pricing documentation should contain enough detail for a proper risk assessment and to serve as the basis for a possible tax audit. Tax administrations can then by specific request or in the course of such audit ask for additional information or documents. The most effective way to limit the administrative burden is by international harmonization of documentation requirements. The initiatives by the EU, PATA and OECD evidence that tax administrations and intergovernmental organizations also recognize this.

The application of the proportionality principle in case of CCA related documentation is well illustrated by an Italian court case from 2005.³²¹ As reported by a correspondent of the IBFD's International Transfer Pricing Journal this case concerned an MNE with subsidiaries in Germany, France, the United Kingdom and Switzerland that performed intra-group services³²². Using a CCA the costs involved were recharged to other group members, among which an Italian subsidiary. This was documented by a CCA contract providing a general description of the cost shared activities and including the names of employees involved in the activities. The contract also outlined the related costs and how they were to be allocated among participants. This was supplemented by samples of invoices with a high-level description of services performed, accounting documents on the computation of total costs and a statement from an accounting firm confirming their computation and allocation in accordance with the contract.

Even though the tax burden in the jurisdictions of the service providers was similar to that in Italy and there was no reason to shift profits to these countries, the Italian tax authorities denied a deduction for charges under the CCA for a lack of proper documentation. They argued that the CCA contract and the sampled invoices did not include a detailed enough description of the specific services actually performed. As such the available documentation in their view

321 Provincial Tax Court of Milan, Chamber VIII, Decision 158, 28 June 2005.

322 Saccardo, International Transfer Pricing Journal 2006/2.

did not prove that there was a benefit from the activities for the Italian CCA participant nor did it properly rule out the possibility that the costs charged included shareholder costs. The taxpayer disagreed and appealed to the Provincial Tax Court of Milan. In front of the Court the taxpayer pointed out that it conflicted with the guidance from the Italian Ministry of Finance for the tax authorities to automatically deny the deductions without a further analysis. Had such further analysis been performed, it would, in the view of the taxpayer, have shown that the services underlying the CCA charges did in fact have a benefit as they increased the efficiency of the taxpayer's business. The Court started its ruling by considering that under Italian tax law in cases like these it is the obligation of the taxpayer to prove the existence of costs and their benefit. However, it then continued to acknowledge that it is a common market practice for MNEs to share the costs of centralized activities. In the Court's opinion the available documentation convincingly showed that the costs were actually incurred, while the description of activities included in the CCA contract in combination with the sampled invoices and the accountant's statement were considered sufficient proof of a benefit transferred onto the Italian group company. Therefore, the Court ruled in favor of the taxpayer and allowed for a deduction of the CCA charges.

In my opinion the decision of the Italian court is in line with the OECD guidance on proportionality. As such it requires taxpayers to prepare a thorough set of documents, but at the same time it also limits the overall complexity of that documentation and the consequential administrative burden on the taxpayer. Complying with this obligation places the burden of proof back with the tax administration, which would then have to evidence that the intercompany charges under a CCA are not at arm's length. Furthermore, the ruling of the Provincial Tax Court of Milan is specifically helpful for the Italian fiscal practice, because it identifies quite explicitly what documentation was considered decisive to prove the existence of costs and their benefit.

7.7. Conclusions

The key findings of this Chapter 6 are as follows,

In respect of the burden of proof:

- (i) The principle based approach of transfer pricing rules and the natural information inequality between taxpayer and tax administrations have resulted in a trend for tax administrations to introduce documentation requirements shifting the burden of proof in transfer pricing matters on to taxpayers. This

also impacts the way in which the burden of proof is divided up in case of uncertainty about transactions taking place under a CCA. Those transactions will therefore also have to be thoroughly documented.

In respect of the documentation requirements applicable to CCAs:

- (ii) The OECD Transfer Pricing Guidelines and the PATA Documentation Package prescribe an extensive list of information that should be included in that contract (see Paragraph 7.3.2 and 7.4). The CCA contract is the anchor point of CCA related documentation. It is further supplemented by the background information on the arrangement provided in the company's transfer pricing master file, local files and country-by-country report. Quite relevantly that should provide the reader of those reports insight into the type of intangibles used, their role in the MNE's value chain and its organizational set-up. Those elements should allow qualification of the CCA using the categorization model presented in paragraph 2.3.3.2, which subsequently should be taken into consideration when testing the arm's length nature of the terms and conditions of such arrangement. Additionally, taxpayers should maintain an accurate administration evidencing the costs, intercompany charges and income associated with the CCA activities. Furthermore, taxpayers should be able to substantiate the valuation of contributions under the arrangement, for example by preparing valuation reports or benchmarking studies.
- (iii) The foregoing can impose a significant constraint on taxpayers. Transfer pricing documentation requirements can be considered the logical answer to the information dissymmetry gap that exists between tax administrations and taxpayers. At the same time they should remain reasonable. International standardization can help to limit the administrative burden and in that respect progress has been made due to the initiatives of the OECD, PATA and EU. I strongly believe however that tax administrations should continue to observe the proportionality of the requirements in practice on a case by case basis. In that context the decision of the Provincial Tax Court of Milan offers an example of when they should be satisfied with how taxpayers document their CCAs.

Part 3: International Tax Law

8. Tax Treaty Qualification

8.1. Introduction

The previous, second part of this study dealt with the transfer pricing aspects of CCAs and addressed the allocation of profits among participants. That determines in the hand of which group company those profits are taxed. The next step is to consider in which state or states that taxation will be imposed. This will depend on the national law of the state or states with which the group company or the source of the income has a certain connection as well as on the tax treaties concluded by those states. Generally states will regard themselves entitled to tax the income of the companies that they consider their residents. This is referred to as the residence principle. In addition most states also aim to tax transactions that take place within their territory or assets that reside within their territory. This is referred to as the source or situs principle. The application of both the residence and situs principle in respect of the same profits can cause the tax claims of different countries to overlap and may result in the taxation of one legal entity's income in two different jurisdictions. This is referred to as juridical double taxation.³²³ Juridical double taxation is distinguished from economic double taxation. The latter occurs when the same income is regarded taxable profit of two different legal entities (see Paragraph 3.1).

It is commonly accepted that any form of double taxation has negative effects on international commerce. By consequence it limits economic growth and global prosperity. For that reason states try to prevent it through unilateral measures and through the tax treaties they conclude with other states. The first bilateral tax treaties date back to the nineteen twenties. Already in 1928 the League of Nations developed a first model bilateral tax convention. After the Second World War the Organization for European Economic Co-operation (OEEC), the predecessor of today's OECD, also recognized the importance of an extended international treaty network and published a model tax conven-

323 Vogel describes juridical double taxation as *"the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for the same identical periods"* (See Vogel 2015, page 1).

tion of its own. In addition several countries have since then drafted a national model tax convention. In today's world the model tax conventions of the OECD, the United States and the United Nations can be considered most important. However, none of these explicitly address specific tax issues arising in relation to the use of CCAs.

This Chapter 8 further discusses the position of CCAs under international tax law in general as well as tax treaties in specific and considers the risk of juridical double taxation of CCA participants. It does so by investigating to what extent the conditions of a CCA can result in a tax liability of participants outside their country of residence. Foreign tax can be imposed on the participant directly, if it would be considered to have a permanent establishment outside the state of which it is a resident. However, Paragraph 8.2 explains why the participation by itself should generally not result in a permanent establishment. Alternatively, foreign tax can be imposed indirectly via a source state withholding tax on balancing payments. Paragraph 8.3 analyzes under what conditions such withholding tax is payable. Finally, Paragraph 8.4 discusses why it can be considered unlikely that a foreign tax liability is to result from the use of immovable property in the course of a CCA.

8.2. Permanent Establishments

Under Article 7 of the OECD, UN and US model tax conventions business profits are as a main rule exclusively taxable in the taxpayer's state of residence. However, an exception applies to the extent that the profits are attributable to a permanent establishment ("PE") in another state. The definition of a PE is provided for by Article 5 of the model tax conventions. It is described as "*a fixed place of business through which the business of an enterprise is wholly or partly carried on*". If such fixed place of business exists, the exclusive right to tax the profits attributable to the PE shifts to that other state and the residence state has to provide relief from double taxation, either by exempting the profits or granting a tax credit. This mechanism effectively places PEs at par with foreign subsidiaries in the sense that their profits are primarily taxable in the source state.

Considering the above it is quite relevant whether a participation in a CCA can by itself cause a PE and, consequently, a foreign tax liability of the participants. For this to be the case the resources made available by one participant would have to constitute a fixed place of business for one or more other participants, through which they carry on all or part of their business. The analysis of whether these conditions are met can be facilitated by considering three variations (scenario 1, 2 and 3) of a single stylized example involving Company A, a resi-

dent of country A, and Company B, a resident of country B. These companies both belong to the same multinational group. Among other activities the group engages in the manufacturing and sale of product X. Company A owns the existing know-how and technology required to manufacture product X, while Company B owns laboratory facilities in country B and employs an experienced R&D team. Driven by customer demand and a desire to preserve its competitive market position the group wants to develop the next generation of product X, product X-2.0.

In scenario 1 Company A solicits Company B as a contract researcher to perform the required R&D activities. Company A will be the owner of the outcome of the research, but also bears the risk of failure. Company B receives a market based hourly rate for time spent by the R&D employees irrespective of whether the research is a success or a failure, but it will not have any ownership rights on the know-how and technology related to product X-2.0. Although Company B's R&D personnel will carry out the day-to-day research, Company A's personnel will take the relevant decisions to control the risk associated with the R&D activities. That includes decisions to enter into or terminate the contract research agreement, decisions about the type of research and decisions about the available budget. Furthermore, Company B's personnel would report back to Company A's personnel on a regular basis. However, Company A only has restricted access to the laboratory and cannot issue specific instructions to the R&D team about the day-to-day performance of activities. Under these circumstances the relationship between Company A and Company B is clearly that of a principle and a service provider. That should in most cases not cause the principle to have a permanent establishment in the country of the service provider. This is also explicitly confirmed in the Commentary to Article 5 of the OECD Model Tax Convention:

"Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through

that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services."³²⁴

There were no reservations made on this Paragraph 42 of the Commentary by any of the OECD Member States, while out of the non-member states that submitted their position India was the only country to express a deviating view.³²⁵ As such, it can be concluded that in scenario 1 Company A would generally not be considered to have a permanent establishment in country B.

In scenario 2 Company A again intends to develop product X-2.0, only this time Company B rents out the laboratory facilities and assigns its R&D employees to Company A. Again Company A will become the exclusive owner the outcome of the research, while this time Company A pays a businesslike rent for the use of the laboratory and the salary of the R&D personnel plus associated costs. Just like in scenario 1 the risk controlling decisions are taken by Company A's own employees in country A and the day-to-day research is performed by the R&D team in country B. However, Company A now has unlimited access to the laboratory and it can issue specific instructions to the R&D team in respect of its day-to-day activities. Under these conditions it is more than likely that the rented laboratory is in fact regarded a fixed place of business at the disposal of Company A through which the assigned R&D team carries on a part of the business of Company A. By consequence, in this scenario 2 Company A would generally be regarded to have a permanent establishment in country B. Under treaties based on the OECD Model Tax Convention the attribution of profit to the PE would then be governed by the Commentary to Article 7. This prescribes that the attributed profit should be the same as when "*the permanent establishment had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions*".³²⁶ In this stylized example it is

324 Commentary to Article 5 of the OECD Model Tax Convention, Paragraph 42.

325 India is of the view that where a company resident of a state is a member of a multinational group and is engaged in manufacturing or providing services for and on behalf of another company of the same group which is resident of another state, then the first company may constitute a permanent establishment of the latter if the other requirements of Article 5 are satisfied.

326 Commentary to Article 7 of the OECD Model Tax Convention, Paragraph 2, under 17.

reasonable to assume that the functional and factual analysis would show that such profit is equal to the difference between the arm's length price for the time spent by the R&D team and their cost. In other words, the attributed profit would equal the profit from contract research activities that would have been reported as taxable profit of Company B in Country B under scenario 1.

Having established the outcome in the foregoing more black and white scenarios, now let's consider scenario 3, in which Company A and Company B decide to jointly develop product X -2.0 under a CCA. Company A contributes the knowledge and know-how on the development of the original product X and Company B makes the laboratory facilities and the R&D team available. Company A and Company B will jointly come to own the know-how and technology to manufacture product X-2.0, which they will each be exclusively allowed to exploit in their own region. The profits from such exploitation are expected to be equal. The day-to-day research is performed by the R&D team, but the risk controlling decisions are proportionally split between Company A and Company B. Company B pays an arm's length buy-in payment for the pre-existing know-how and technology to Company A, while Company A compensates Company B for making available the laboratory facilities and R&D team through balancing payments consisting of a market based hourly rate for time spent by the R&D employees.

Just like in scenarios 1 and 2 there is in scenario 3 no reason to doubt that the laboratory facilities and the R&D team constitute a fixed place of business. More relevantly it would have to be determined whether this is at the disposal of Company A and whether the business carried on there is that of Company A. In my opinion this is in principle not the case. Crucial elements are that the legal right to freely access and use the laboratory facilities remains exclusively with Company B and that the R&D team remains fully employed with Company B. The R&D personnel is not obliged to take orders directly from Company A. As such, it cannot be said that the laboratory or the R&D team are placed at the disposal of Company A. That Company B applies these resources to make a contribution under the CCA does not change anything in this respect. To the contrary, Company B is rewarded for its contribution with the profit element included in the open market rent and the competitive hourly rate of R&D personnel used as the basis to value Company B's contribution and to calculate Company A's balancing payments. As such, the resources should be considered to be used to carry on the business of Company B and not the business of Company A. Furthermore, as the balancing payments are already part of Company B's taxable income, there would be no profit left to attribute to the PE anyway.

The foregoing analysis is confirmed by the results of a survey performed by the IBFD's International Transfer Pricing Journal in 2001. None of the respondents from 14 different countries considered it likely that participation in a CCA would result in recognition of a PE in their jurisdiction.³²⁷ Nevertheless there might still be some room for discussion, particularly when the contribution of R&D resources would not be valued at market price but at cost. In that case all the profits stemming from the undivided half of the work of the R&D team would end up with Company A. That the R&D team performs its activities in country B might inspire the tax authorities of country B to claim that there is a permanent establishment, to which at least some part of the profit should be attributed. They might consider that they are entitled to tax that profit and argue that the CCA is only a legal instrument to artificially avoid a permanent establishment. To promote clarity and avoid disputes I therefore propose adding the following new sub-paragraph to the guidance provided in Paragraph 42 of the Commentary to Article 5 of the OECD Model Tax Convention:

"A company that is a member of multinational group cannot be considered to have a permanent establishment only because it participates in a cost contribution arrangement as defined in Chapter VIII of the OECD Transfer Pricing Guidelines and another company of the same multinational group performs activities or makes available resources under such arrangement that may provide the former company with an economic benefit. By definition all participants in a cost contribution arrangement have the expectation that they will benefit from the objectives of that arrangement. However, that does not mean that the place of business where one participant performs activities or where the resources made available by that participant are located is at the disposal of the other participant(s) nor does it mean that the business of the other participant(s) is carried on through that place of business."

Including this wording in the Commentary would clarify that a tax administration that is dissatisfied with its ability to tax profits from a CCA as defined in Chapter VIII of the Transfer Pricing Guidelines, cannot argue that an excessively benefiting foreign participant has a permanent establishment and a corresponding tax liability in its jurisdiction. Alternatively, this tax administration would have

327 The survey covered Australia, Germany, the Netherlands, South Africa and the UK (International Transfer Pricing Journal, 2001 (Volume 8) No. 2, IBFD), Belgium, Canada, France, Spain and the United States (International Transfer Pricing Journal, 2001 (Volume 8) No. 3, IBFD), Luxembourg and Hungary (International Transfer Pricing Journal, 2001 (Volume 8) No. 4, IBFD) and Portugal and Denmark (IBFD, International Transfer Pricing Journal, 2001 (Volume 8) No. 6, IBFD).

to challenge the arm's length nature of that CCA and pursue a transfer pricing adjustment.

8.3. Withholding Tax on Balancing Payments

8.3.1. Introduction

As discussed extensively in Part 2 of this thesis, the outcome of a CCA will only be in line with the arm's length principle, if each participant's contribution is consistent with its expected benefit from cost shared activities. If this is not the case, then the overall contribution of at least one participant will be inadequate, while the overall contributions of at least one other participant will be excessive. To appropriately compensate for this, balancing payments should be made between the participants (also see Paragraph 5.6). These balancing payments will generally be included in the taxable income of the payee in its country of residence on the basis of the residence principle. However, the payer's country of residence may also feel it has a right to tax the payments on the basis of the situs principle. It could collect such tax by requiring the payer of the balancing payment to withhold a certain amount from the balancing payment to the foreign CCA participant and remit that to the local tax authorities. If the residence state and source state have entered into a tax treaty, the qualification of the balancing payments under such treaty will determine the level of taxation the source state may impose and the way in which the residence state has to provide for avoidance of double taxation.

8.3.2. Tax Sharing

To further understand the tax treatment of balancing payments under bilateral tax treaties, it has to be observed that these treaties generally seek to avoid double taxation in respect of certain types of, mostly passive, income through so called tax sharing. This income is then subject to full taxation in the residence state and a limited tax in the source state, for which the residence state provides relief from double taxation. Tax sharing, as Vogel puts it, *"is a typical compromise to settle a clash between the State of source and the State of residence in cases in which both believe that they have justified claims to tax jurisdiction that they do not want to forgo completely"*.³²⁸ The compromise offered by tax sharing consists of dividing up the imposed amount of tax between the contracting states. To achieve this, the residence state is principally entitled to subject the

³²⁸ Vogel 2015, page 708.

income concerned to full taxation under its national rules, while the source state is allowed to impose a limited tax on that same income. The residence state then generally grants the taxpayer a proportionate exemption or a tax credit for this source state taxation.

For practical reasons the source state taxation is in most cases withheld at the level of the payer. This is generally considered an efficient way for tax administrations to collect tax from non-residents earning income with a certain nexus to their jurisdictions.³²⁹ However, by nature these so called withholding taxes do imply a risk of over-taxation. This is because withholding taxes in most cases are levied on gross income. By consequence the effective tax rate can be unreasonably high, if there are significant costs associated with the income. That not only imposes an unreasonable burden on the taxpayer, but in effect also shifts all taxation to the source state. The reason for this is that the tax credit granted to the taxpayer in the residence state will normally be limited to the tax paid on the same income in that state. If the residence state allows for a deduction of related expenses before taxing the net income, it could be that the tax payable in that state is actually less than the withholding tax levied in the source state and that the credit neutralizes all residence state taxation.³³⁰ In the context of CCAs, the foregoing is potentially most problematic in respect of balancing payments intended to compensate a participant for performing low value adding activities. For example, a company participating in a CCA aimed at developing relatively simple process technology may value the work of its R&D team at costs plus a profit mark-up of 10%. Assume this company incurs costs of 100 for which it receives balancing payments of 110. If the statutory tax rate in its country of residence is 30%, it would principally pay local corporate income tax of 3 $((110 \text{ income} - 100 \text{ costs}) * 30\%)$. If the balancing payment is subject to 10% withholding tax in the source state, it would pay an additional 11 $(110 \text{ gross receipt} * 10\%)$ in the source state. The country of residence will then generally grant a tax credit of 3, which implies a full refund of the corporate income tax that it levied. Nevertheless, the recipient of the balancing payment pays source state tax of 11 over a profit of 10, which still implies an effective rate of 110%.

329 The OECD considered withholding systems “*effective tax collection mechanisms due to their inherent ability to collect tax at the point that income is earned, promote voluntary compliance through third party reporting and ensure stable and timely cash flows to government*” - OECD, Centre for Tax Policy and Administration, “*Compliance Risk Management: Managing and Improving Tax Compliance*”, 2004, page 53.

330 For a comprehensive analysis on the impact of withholding taxes see Camacho Palma, Intertax 2010/12.

The OECD Model Tax Convention applies tax sharing in respect of dividends and interest.³³¹ The UN Model Tax Convention and many bilateral treaties, even those otherwise based on the OECD Model, do the same in respect of royalties.³³² Furthermore, there are also a number of bilateral tax treaties that apply tax sharing in respect of fees related to the transfer of technology or know-how and non-passive income from rendering (technical) services. For this purpose some countries have in their bilateral tax treaties incorporated technical services into the definition of royalties.³³³ Others have in their tax treaties introduced separate articles covering technical services income.³³⁴ In this context it also deserves mentioning that there is a proposal pending with the UN Committee of Experts on International Cooperation in Tax Matters to introduce a new article on technical services allowing for source state taxation in the UN Model Tax Convention.³³⁵

It is of course quite unlikely that arm's length balancing payments under a CCA can be qualified as dividends or interest. It may however be less evident whether they do or do not qualify as royalties or service fees. As such, there is a realistic chance that under certain tax treaties they could be subjected to source state withholding taxation. In order to assess if and when a withholding tax may be imposed on balancing payments a closer look at the general concepts of royalties and service fees is helpful.

8.3.3. The General Concepts of Royalties and Services

Most bilateral treaties provide for a definition of royalties. In the OECD Model Tax Convention that definition is included in Article 12, Paragraph 2:

"The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright or literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial commercial or scientific experience."

Many countries have also included definitions of royalties in their own national law. It follows from Article 3, Paragraph 2, of the OECD and UN Model Tax

331 See Article 10 and 11 of the OECD Model Tax Convention.

332 See Article 12 of the UN Model Tax Convention.

333 Examples are Brazil, India, Portugal and Spain.

334 This approach was followed by a number of African countries.

335 B. Arnold, "Note from the Coordinator of the Subcommittee on Tax Treatments of Services: Draft Article and Commentary on Technical Services", 30 September 2014, E/C.18/2014/CRP.8. For a further analysis of the proposal see Moreno, World Tax Journal 2015/3.

Conventions that these are principally overruled by the treaty definitions. The definitions under national law may however still be used for treaty interpretation purposes.³³⁶

In respect of a definition of services there is much less to go by. Both national law and tax treaties seldom provide a clear definition. That can be considered remarkable, because in many jurisdictions the tax treatment of payments depends on their possible qualification as a service. It also surprised the composers of the 2012 IFA Report. Left to their own devices the IFA branch reporters agreed that normally a broad range of activities could be labeled as a service. They concluded that *"activities involving functions performed by one or more individuals at a particular location for the benefit of another person would generally be regarded as services"*.³³⁷ Wijnen, De Goede and Alessi used a similarly broad definition for their research into the position of services under tax treaties. They assumed that *"services comprise any work done for another person for remuneration"*.³³⁸ A third definition can be found in the Commentary to the OECD Model Tax Convention that describes contracts for the provision of services as contracts, *"in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party"*.³³⁹ In these and other definitions of services commonly available there is always a certain level of activity supposed on the side of the supplier. It therefore appears reasonable to conclude that a passive passing on of costs will by itself not qualify as a service. Further, it is worth noticing at this point that the Commentary to Article 12 of the OECD Model Tax Convention provides some guidance to the distinction between royalties and services:

"A payment cannot be said to be 'for the use of or the right to use' a design, model or plan if the payment is for the development of a design, model or plan that does not already exist. In such a case, the payment is made in consideration for the services that will result in the development of that design, model or plan and would thus fall under Article 7. This will be the case even if the designer of the design, model or plan (e.g. an architect) retains all rights, including the copyright, in that design, model or plan. Where, however, the owner of the copyright in previously-developed plans merely grants someone the right to modify or reproduce these plans without actually performing any additional work, the payment received by that owner in

³³⁶ Also see Vogel 2015, page 206.

³³⁷ Pickering et al 2012, page 27.

³³⁸ Wijnen, De Goede and Alessi, Bulletin for International Taxation 2012/1.

³³⁹ Commentary to Article 12 of the OECD Model Tax Convention, Paragraph 11.2.

considerations for granting the right to such use of the plans would constitute royalties."³⁴⁰

Furthermore, payments for the supply of know-how, i.e. information concerning industrial, commercial or scientific experience, are explicitly considered a royalty. To distinguish the supply of know-how from the rendering of technical services, it should be taken into account that:

- (i) Know-how is pre-existing information;
- (ii) The supply of know-how would involve an actual transfer to the other party and that extends beyond know-how only being used by a supplier in the course of performing a service; and
- (iii) Know-how can in most cases be supplied without additional activities being performed by the supplier.³⁴¹

All this makes it quite clear that a payment can only be regarded a royalty, if it is a consideration for the use or right to use a pre-existing intangible. By consequence, payments related to the development of new intangibles that will become the effective ownership of the payer do not qualify as a royalty. So called mixed contracts covering both the supply of know-how and the provision of services should according to the OECD Commentary be broken down into separate elements that then each should be given their own appropriate tax treatment, unless one element is clearly the dominant purpose of the contract:

*"The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration."*³⁴²

³⁴⁰ Idem, Paragraph 10.2.

³⁴¹ Idem, Paragraph 11.3.

³⁴² Idem, Paragraph 11.6.

A more or less identical approach can be found in the Commentary to the UN Model Tax Convention.³⁴³ As will be discussed in Paragraph 8.3.4.2 below this guidance can be relevant, when pre-existing intangibles are made available under a CCA.

8.3.4. Can Balancing Payments Qualify as Royalty Income?

8.3.4.1. General Rule: Balancing Payments Do Not Qualify as Royalty Income

As already acknowledged above many bilateral tax treaties, including those otherwise based on the OECD Model Tax Convention, allow for a source state taxation on royalties and would therefore allow for source state taxation on balancing payments, if those qualified as such. It is probably for that reason that the OECD provided some relevant guidance on the qualification of balancing payments as royalties in the 1997 version of Chapter VIII of the Transfer Pricing Guidelines. This guidance, which was no longer included in the Transfer Pricing Guidelines after their revision as part of the BEPS project, explicated that:

"...a balancing payment would not constitute a royalty for the use of intangible property, except to the extent that the payment entitles the payer to obtain only a right to use intangible property belonging to a participant (or a third party) and the payer does not also obtain a beneficial interest in the intangible property itself".³⁴⁴

The statement may be better understood, if it is acknowledged that the new intangible property developed under the CCA itself is not the subject of a transaction under that arrangement. The effective ownership of this intangible property is in most cases shared proportionally among the participants community from the moment it comes into existence. Neither the ownership of the new intangibles nor a right to use the new intangibles is transferred between the payer and payee of a balancing payment. As such, CCAs should be distinguished from make-sell license agreements, which allow a licensee to use an intangible to manufacture a product and perform a service without that licensee becoming the owner of the intangible (also see Paragraph 5.5.2.3.1). By consequence, balancing payment can generally not be regarded a consideration for the use or a right to use the intangibles that are newly developed under the CCA. As such,

³⁴³ Commentary to Article 12 of the UN Model Tax Convention, Paragraph 11.6.

³⁴⁴ OECD Transfer Pricing Guidelines, Paragraph 8.25 (old).

they should not be qualified as a royalty nor be subjected to withholding tax on that ground. However, there might be royalty withholding tax still.

8.3.4.2. *Exception: The Payer Obtains Only a Right to Use*

8.3.4.2.1. *A Lack of Beneficial Interest*

According to the meanwhile revised text of Paragraph 8.25 of the Transfer Pricing Guidelines, balancing payments may in deviation from the general rule be qualified as a royalty and thus subjected to royalty withholding tax, if the payer receives a right to use intangible property but "*does not obtain a beneficial interest in the intangible property itself*". For as far as I have been able to determine, this could be the case in either one of two situations:

- (i) The balancing payments relate to pre-existing intangibles being made under the CCA, which are not merely of an auxiliary and largely unimportant character;
- (ii) The balancing payments relate to the development of new intangibles, but the effective ownership of these new intangibles is not proportionately shared among the participants.

In the first of these situations the CCA covers both the making available for use of pre-existing intangibles and the joint development of new intangibles. As such, it will be considered a mixed contract (see Paragraph 8.3.3). The Commentary to both the OECD and UN Model Tax Conventions then prescribe that the consideration should be broken down into parts according to what is provided under the arrangement. Living up to this guidance would require splitting up the balancing payments between the different contributions, after which the part that relates to making pre-existing intangibles available is treated as a royalty payment.

In the second situations new intangibles are developed, but, contrary to the common purpose of a CCA, the effective ownership of those intangibles is not shared proportionally among the participants. This implies that certain more privileged participants hold a more absolute ownership over the intangibles, while others hold only a limited right. For example, the more privileged participants may be able to sell, license or lease the intangibles to third parties, whereas the less privileged participants are only allowed to make use of the intangibles. Under these circumstances the arrangement actually is more similar to a make-sell license than to a CCA. In that case the more privileged participants should

be considered to have developed or obtained the intangibles for themselves and to have subsequently licensed them out to the less privileged participants. Source states are specifically inclined to argue that a disproportionate allocation of the ownership of intangibles entitles them to tax balancing payments, if the applicable tax treaty includes a broad definition of royalties. Examples of such situations can apparently be found in Portuguese case law of the late nineteen eighties and early nineteen nineties. When the International Transfer Pricing Journal performed a comparative study of the tax treatment of CCAs in 2001, the respondent for Portugal reported on an appeal by Dutch – British oil company Shell that had concluded a CCA, under which services were performed for the benefit of group companies worldwide including those in Portugal.³⁴⁵ The arrangement was such that the costs incurred in relation to the services were recharged, but no profit mark-up was added. For certain services the subsidiaries' turnover of oil products was used as a cost allocation key, while for others a direct allocation method was applied. Any patent or know-how developed through the services was made available for use to Shell Portugal without further charge. Under these circumstances the Portuguese Tax Courts considered the balancing payments were similar to a royalty and allowed for a withholding tax. As is explained by the 2001 report in the International Transfer Pricing Journal, this was because *"the Portuguese Tax Courts concluded that the taxpayer had not sufficiently proven that:*

- (i) payments merely corresponded to a specific refund of expenses previously incurred by Shell International;*
- (ii) there was a common fund of all the companies that entered in such agreements; and*
- (iii) [pre-existing] know-how was not transmitted [i.e. made available] to Shell Portuguesa".*³⁴⁶

The foregoing obviously raises questions about exactly when a disproportionate allocation of ownership of results justifies a qualification of balancing payments as a royalty. In my opinion two conditions would have to be met:

³⁴⁵ Shell International Chemical Company Limited v. the tax authorities (Fazenda Pública), 21 February 1990, Appeal 11.935.

³⁴⁶ De Sousa da Câmara, International Transfer Pricing Journal, 2001/6.

- (i) the payer effectively should receive nothing more than a right to use the newly developed intangibles; and
- (ii) the payee should hold a more absolute ownership.

I would advocate letting the economic substance prevail over the legal form of the arrangement when testing whether these conditions are met. This would have the important advantage that balancing payments are not qualified as a royalty, only because the payer does not hold the legal ownership of the newly developed intangibles. That leaves open the possibility to centralize the legal ownership of cost shared intangibles with one participant, which is considered to allow for better legal protection of intangible property. Under such substance over form approach it would be quite critical to assess not only how the payee may legally use the intangibles, but also what use the payer is economically expected to make of the intangibles. The relevance of this distinction is illustrated quite well by a contradicting public transfer pricing ruling and High Court decision in India.

8.3.4.2.2. *The Indian ABB Ruling and CGI Case*

On 15 March 2010 the Authority for Advance Rulings of New Delhi ("ARR") published a ruling issued to ABB Ltd, an Indian subsidiary of a worldwide group specialized in power and automation technologies. This company was entering into a CCA covering the basic R&D activities.³⁴⁷ The corporate research and development program was coordinated by a Swiss group company, ABB Zurich. The latter company engaged several intragroup Corporate Research Centers to perform the R&D activities and it remunerated those on a cost plus basis. The various participants in the CCA shared in the overall costs on the basis of a pre-fixed allocation key in proportion to the "value added" achieved by each of them. Furthermore, they paid a coordination fee to ABB Zurich. The CCA contract provided for all participants to become joint effective owner of resulting intangibles with unlimited royalty-free access to those intangibles, while for administrative reasons only ABB Zurich was appointed legal ownership of intangibles. Any royalty income that ABB Zurich would earn from licensing out the intangibles to other parties was to reduce the R&D costs shared among the participants. In the ruling request ABB Ltd accepted that the coordination fee paid to ABB Zurich suffered an Indian withholding tax, but at the same time argued that the balancing payments for access to the newly developed intan-

347 The Authority for Advance Rulings of New Delhi (India), A.A.R. No. 834 of 2009, 15 March 2010 (ABB Ltd).

gibles should not subject to such tax. The ARR went along with the taxpayer's positioning. In reaching its decision the ARR explicitly took into account that the terms of the agreement allowed for each participant "*to avail of the fruits of research in its own right*". It also referenced specifically how the proceeds from the further commercial exploitation of the intangibles by ABB Zurich were applied to reduce the R&D costs shared by participants. These considerations, together with the manner in which the funding was arranged and the cost basis was determined, led the ARR to conclude that the payments made by ABB Ltd did not qualify as royalty payments that could be subject to Indian withholding tax. The fact that the legal ownership of the intangibles was centralized with ABB Zurich did not affect the outcome. In the more recent CGI case however the High Court of Karnataka followed a marginally different reasoning, leading to a completely different outcome.³⁴⁸

CGI is a Canadian headed group active in the IT-sector with a subsidiary in India. CGI Canada entered into a CCA with a number of its subsidiaries to develop an intranet facility for common use throughout the group. CGI Canada initially paid for all development costs, including a substantial Microsoft license. The CCA participants were invoiced a proportionate share of these costs without any profit mark-up. In return they were permitted to make use of the intranet facility in their day-to-day business. At the same time however the absolute ownership of the facility remained with CGI Canada and the other participants could not sell, license or lease the facility. In fact the only right granted to the other participants under the cost sharing agreement was a right of use. CGI India argued that payments under the CCA were intended to reimburse expenses, that they were not service fees or royalties and that there was no Indian withholding tax due on these payments. The Indian Commissioner of Income Tax disagreed. He qualified the payments as a royalty and imposed a corresponding withholding tax. The case was brought to court and the Income Tax Appellate Tribunal of Bangalore ruled in favor of the taxpayer. The Commissioner then appealed before the High Court of Karnataka.

The High Court considered that it makes no difference in the eyes of the law that the invoices sent to CGI India did not include any profit or income element. It also added explicitly that it made no difference in this context that the Canadian company acquired a substantial part of the intangible property by way of lease from Microsoft instead of independently developing the property by itself. The Court on the other hand did regard it to be "*of utmost importance*" that the underlying agreement explicitly stated that the absolute ownership of

³⁴⁸ CIT v. CGI Information Systems and Management Consultants Private Limited, 9 June 2014, ITA No.209/2008.

the facility remained with CGI Canada. This led the High Court to conclude that it was not the intention of the CCA to equally vest the title of the facility among the participants. Taking this into account, the High Court concluded:

"If CGI group companies were to pay costs for using the said facility, then the title of the said facility i.e. intellectual property should equally vest proportionate to the cost share by [these] group companies. That is not the intention behind this agreement. Therefore, we have no hesitation to hold that this Cost Sharing Agreement is only a device to avoid payment of tax as contemplated under the aforesaid provision. It is nothing but a royalty. Therefore, the order passed by the Tribunal is erroneous and requires to be set aside."

In my opinion the decision of the High Court is quite formalistic and pays insufficient attention to the economic reality of the case, specifically the position of CGI Canada. It is unclear whether a clause in the CCA contract requiring CGI Canada to share any proceeds from licensing out the intangibles, similar to the provision that the ABB group used in its arrangement, would have led to another outcome. However that may be, the High Court disregards that an intranet facility is in most cases for internal use only and that CGI Canada's right to sell, license or lease the facility may have little or no practical value. By consequence, it appears reasonable to argue that the effective ownership was in fact proportionately shared among the participants. Instead the High Court regarded it decisive for the final tax treatment of the balancing payments that the absolute ownership formally remained with CGI Canada and found reason in that to qualify the balancing payment as a royalty. With this ruling the Court takes a step back compared to the earlier ABB ruling. That appears to significantly increase the risk of an Indian withholding tax liability on balancing payments under any CCA contract that centralizes legal ownership of intangibles with one participant and does not explicitly grant sufficient effective ownership to other participants.

8.3.5. Can Balancing Payments Qualify as Services Income?

8.3.5.1. Introduction

If balancing payments are not qualified as royalty income, they may yet be subjected to withholding tax on services income. The OECD generally advocates exclusive residence taxation of services that are not attributable to a permanent

establishment.³⁴⁹ Various countries however have another opinion and impose a withholding tax on services income under their national laws. Some of these countries, including major economies like India and Brazil, have also reserved a right to tax fees paid for technical services in the royalty article of their tax treaties. However, in these countries it has not been undisputed when and how such withholding tax can be effectuated. In some situations it appears to be a critical aspect whether the payments are merely intended to share expenses or whether there is a profit element included and therefore they qualify as income in the hands of the recipient.

8.3.5.2. *The Indian Shell Ruling and M/s. C. U. Inspections Case*

The Authority for Advanced Ruling of New Delhi was quite clear in the ABB ruling. In the case presented to the ARR there, the balancing payments were split up into two parts. There was a coordination fee paid and a compensation payment for access to the intangibles resulting from R&D activities performed by the corporate coordination centers. The coordination fee was subject to withholding tax, the payment for access to intangibles was not. It should be noted that the recipient of the latter payment, ABB Zurich, did not itself perform any development activity. It “outsourced” the work intragroup to dedicated corporate research centers. This led the ARR to hold:

“It cannot be said that ABB Zurich has rendered any service of technical or consultancy nature to the applicant when it makes available to the applicant and other parties to the CCA the result of corporate research. From the statement of facts and the contents of the CCA, it is clear that rendering of any service of the nature of managerial, technical or consultancy is not involved and moreover, ABB Zurich does not deploy any personnel to perform any services in India.”

That decision was not changed by the fact that the corporate research centers were compensated at a cost plus basis, i.e. with a limited profit mark-up added to the amounts of costs shared by the CCA participants. Almost two years later, the ARR came to an exact opposite conclusion in respect of an application by oil company Shell.³⁵⁰

Shell had implemented a CCA, under which various of its operating companies, including Shell India, obtained general business support services from Shell

³⁴⁹ Commentary to Article 5 of the OECD Model Tax Convention, Paragraph 42.11 and further.

³⁵⁰ The Authority for Advance Rulings of New Delhi (India), A.A.R. No. 833 of 2009, 17 January 2012 (Shell India Markets Pvt Ltd).

UK. That included for example services in the fields of procurement, tax and legal. Research and development was explicitly not covered. There was no profit element included in charges to the group company under the arrangement and it was determined that all participating group companies would become the joint owner of any know-how generated through the services. In light of the latter element, the ARR agreed with the taxpayer that payments under the CCA could not be regarded a royalty. That left the ARR to determine whether under the given circumstances they could alternatively qualify as fees for technical services within the meaning of Article 13 of the India – UK tax treaty and, as such, be subject to Indian withholding tax. The ARR acknowledged that this would require the rendering of any technical or consultancy services that make available technical knowledge, experience, skill, know-how or processes or that consist of the development and transfer of a technical plan or technical design. Now the automatic shared ownership of the know-how came back to bite the taxpayer, as the ARR considered it to establish that the services were clearly made available to the applicant. It subsequently concluded that the payments made for availing the general business support services under the CCA qualified as fees for technical services and that the payment received by the UK service provider was therefore subject to Indian withholding tax.

It is difficult to determine what the crucial elements are causing the difference between the ABB and Shell ruling. Perhaps the ARR found it relevant that in the ABB case the group company receiving the payment from the Indian affiliate, ABB Zurich, did not itself perform any R&D services, while in the Shell case the group company receiving such payment, Shell UK, did in fact render the services under review. It would appear quite an arbitrary distinction however, whether or not another group company has been interposed as a CCA coordinator. This leaves plenty of room for uncertainty about the tax treatment of balancing payments. The decision of the Mumbai Income Tax Appellate Tribunal (“ITAT”) in a cost sharing case on 6 March 2013 did not take that away, but does deserve further consideration when trying to better understand the Indian perspective on CCA transactions.³⁵¹

M/s. C. U. Inspections was engaged in “*the business of certification of activities in respect of quantity quality, pre-shipment inspections, surveys etc.*” The company was disallowed an income tax deduction in respect of two types of charges. Firstly, the group’s Dutch holding company incurred certain costs for and on behalf of the Indian company and various other subsidiaries. These costs were related to accounting services, legal and professional services, communication,

351 C.U. Inspections (I) Pvt. Ltd. v. DCIT, 6 March 2013, (ITA No. 577/Mum/2011).

R&D and comparable other activities with a collective benefit. To appropriately reallocate the costs the companies concluded a CCA. Under this agreement the charges to the subsidiaries specifically did not include a profit mark-up. Secondly, the holding company had arranged for a training of the employees of the Indian company by a third party. Obviously the charges from such third party will have included a profit element. However, upon recharging the costs to the Indian subsidiary the holding company explicitly did not add any further mark-up.

The Indian tax administration considered that the CCA charges and training related invoices would only be tax deductible to the Indian company, if a tax at source was withheld upon payment. When M/s. C. U. Inspections brought the case in front of the ITAT the Commissioner further challenged the inherent deductibility of the charges by pointing out that the taxpayer had not provided any details of the actual expenditures incurred. The ITAT concluded however that the absence of a tax withheld at source only justifies the disallowance of a tax deduction with the payer, if there was a withholding tax liability in the first place. Such withholding tax liability requires that the payments are taxable in the hands of the recipient. In respect of the charges under the CCA this was considered not to be the case, because the payments were nothing more than a reimbursement of expenses. Therefore, the ITAT ruled that there was no withholding tax due and that the payments were tax deductible nonetheless. Furthermore, the ITAT decided that the Commissioner could not improve the case of the Indian tax administration at this stage of the proceedings by questioning the inherent deductibility of the CCA charges. By consequence, this argument was rejected on formal grounds.

For the training related invoices the ITAT reached a different conclusion. It established that these were routed via the holding company, but eventually ended up with a third party. The ITAT explained that in such a case the provisions for deduction of tax at source should apply, as if the Indian company made the payments to the third party directly. The mere fact that the holding company did not include an additional profit mark-up was insufficient for the payment to be termed as a reimbursement of expenses. The ITAT further motivated its position as follows:

"...if the contention of the assessee is accepted and the payment to third party, routed through its related concern, is considered as reimbursement of expenses to the related party, then probably all the relevant provisions in this regard will become redundant. Such a route is impermissible to thwart the flow of law."

In respect of the training related income the ITAT redirected the matter back to the assessing officer to assess both the inherent deductibility and the question whether the amounts paid by the Indian company were taxable income in the hands of the third party. By doing so, it appears to deviate from the ARR's decision in the ABB and Shell ruling, which did not consider it a critical aspect whether the costs recharged under the CCA by the coordinating group company included a profit mark-up. There may have been factual differences that caused this deviation. For example, the profit element added to the training charges by the third party may have substantially exceed the limited, cost based profit mark-up used by the corporate research centers of the ABB Group. However, the ITAT did not further comment on this, nor did it consider the earlier discussed ARR rulings at all. However, in light of the prescription under the post-BEPS OECD guidance for the valuation of contributions to generally include a profit element (see Paragraph 5.5.3), the ITAT's decision may still result in more balancing payments becoming subject to Indian withholding tax.

8.3.5.3. *The Brazilian Private Letter Rulings*

In Brazil the tax treatment of CCAs has long been a controversial issue, in respect of which the Brazilian revenue service (*Receita Federal do Brasil* or "*RFB*") has more than once changed its position. In 2012 it issued a private letter ruling, targeting payments under domestic cost sharing arrangements.³⁵² The ruling explicated that it should be possible to centralize support activities and reallocate the related costs to the benefiting group companies, provided that:

- (i) the performance of the activities is necessary, normal and usual for the Brazilian company's business;
- (ii) the costs are actually invoiced to and paid by the Brazilian company;
- (iii) the cost reallocation was calculated on the basis of reasonable and objective criteria, previously included in a formal agreement between the group companies involved;
- (iv) the allocated costs correspond with the actual expenditure per company and the total price paid for goods and services; and
- (v) all acts related to apportionment of costs are properly documented.

³⁵² Receita Federal do Brasil, Resolution of divergence (*Solução de Divergência*) nr. 8/2012, 5 May 2012.

If these conditions were met and it did not concern a mere recharge of the costs for subcontracting services to a third party, then payments would be tax deductible for Brazilian corporate income tax purposes. In 2013 the RFB issued a second administrative decision, which also explicitly exempts the payments meeting the above conditions from liabilities under the federal social integration program and contribution for the financing of social security (*Programa de Integração Social* or “PIS” and *Contribuição para Financiamento da Seguridade Social* or “COFINS”).³⁵³ Furthermore, it has been argued by scholars that as long as there is no profit mark-up included, cross border balancing payments should be tax deductible and not subject to withholding tax.³⁵⁴ Be all that how it may, the RFB has more recently issued several rulings reversing most of the above.³⁵⁵ These rulings considered the provision of general services under a CCA, in respect of which it is concluded that they are not tax deductible for corporate income tax purposes and that they are indeed subject to PIS, COFINS as well as withholding income tax and the contribution for the intervention on the economic domain (*Contribuição de Intervenção no Domínio Econômico* or “CIDE”). Although the positioning by the RFB has not been tested by the Brazilian Supreme Court, this attitude of the tax administration and the notoriously long lead time of Brazilian legal procedures have in practice made it very unattractive for MNEs to enter into CCAs with their Brazilian subsidiaries.

8.3.6. Author's Analysis

Since the BEPS project the OECD requires most contributions to be valued at market price and therefore balancing payments are more likely to include a profit element. There is at least a theoretical basis for sharing the right to tax such profit under tax treaties. However, the risk that taxation of a gross amount leads to an excessively high tax rate is realistic and I am therefore generally not in favor of a tax sharing approach to balancing payments, especially when those relate to development activities or services provided under a CCA. When on the other hand the balancing payments are a compensation for access to pre-existing intangibles, this is more similar to a royalty payment and that might make a different tax treatment more reasonable. It should however in any case be understood that balancing payments are not to be treated as a royalty or subjected to withholding tax on that ground, if they are a consider-

353 Receita Federal do Brasil, Resolution of divergence (*Solução de Divergência*) nr. 23/2013, 23 September 2013.

354 De Moraes e Castro, Bulletin for International Taxation 2015/8.

355 Receita Federal do Brasil, Resolution of divergence (*Solução de Divergência*) nr. 43/2015, 26 February 2015, nr. 50/2016, 5 May 2016, and nr. 69/2017, 14 June 2017.

ation for development activities aimed at creating new intangibles that will be jointly owned by the payer. By consequence, balancing payments should only be subject to a royalty withholding tax, if they are for the use of intangibles that are not effectively co-owned by the payer. This methodology was accurately worded in the old Paragraph 8.25 of the OECD's Transfer Pricing Guidelines (see Paragraph 8.3.4). Although there is no reason to assume that it has become less applicable, the OECD repealed Paragraph 8.25 (old) of the Transfer Pricing Guidelines and replaced it by more ambiguous guidance that indicates:

"Contributions including any balancing payments, by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if the contributions were made outside a CCA, to carry on the activity that is the subject of the CCA. The character of the contribution will depend on the nature of the activity being undertaken by the CCA, and will determine how it is recognized for tax purposes".³⁵⁶

Unfortunately the above statement does not clarify how the balancing payment should have been qualified, if it had been made outside the CCA. That is therefore to be interpreted on the basis of domestic law and applicable tax treaties. Given that the wording from the old Paragraph 8.25 is then still very much appropriate, I would be in favor of re-introducing it. The OECD would then make crystal clear that it remains a critical distinguishing element whether or not the participant making the balancing payment obtains a beneficial interest in any intangible property, to which the payment may be associated. When testing whether such beneficial interest is obtained, I believe a substance over form approach should be used. Most notably the effective ownership should be considered and not the legal ownership. This avoids that the tax treatment of a balancing payment is affected, if the legal ownership is centralized with a single participant while the effective ownership is shared among the broader participants community. The latter can be a desire of MNEs, not for tax reasons but because it offers administrative advantages and allows for more effective legal protection of the group's valuable intangible property. I would therefore further propose to add an additional comment, included in between brackets below, resulting in the following wording:

³⁵⁶ OECD Transfer Pricing Guidelines, Paragraph 8.41.

"...a balancing payment would not constitute a royalty for the use of intangible property, except to the extent that the payment entitles the payer to obtain only a right to use intangible property belonging to a participant (or a third party) and the payer does not also obtain a beneficial interest in the intangible property itself[, whereby the existence of such beneficial interest is to be considered based primarily on the factual exploitation of the intangible property instead of the legal entitlement to the intangible property]."

I would advocate including this there where it systematically belongs, i.e. in the Commentary to Article 12 of the OECD Model Tax Convention. However, even if my recommendations would be followed up, balancing payments not qualified as a royalty may still be subject to withholding tax on services income. In that case the source state should have provided for such taxation in its national law and needs to have negotiated a right to impose it under its bilateral tax treaties. Taking all the foregoing into account, the analysis to determine whether or not balancing payments are subject to source state withholding taxation can be schematically summarized in the following flowchart:

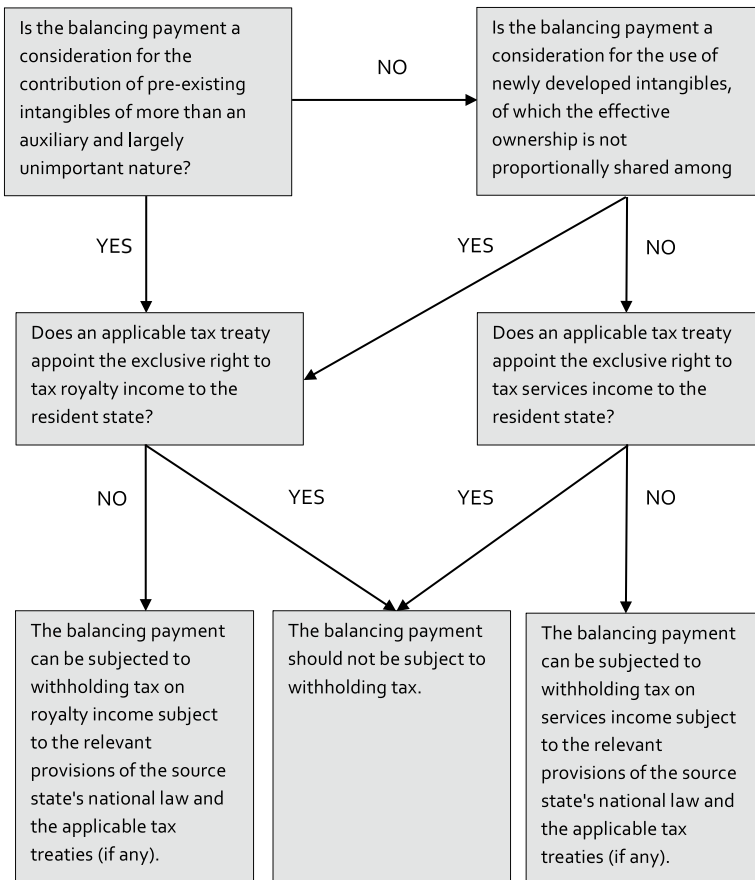


Figure 8: “Flowchart Withholding Tax on Balancing Payments”

8.4. Immovable Property

The allocation under Article 6 of the OECD, UN and US model tax conventions of the right to tax income from immovable property to the state where such property is located is a stereotype example of application of the situs principle. The rationale behind it is that there is always a close economic connection between the source of income, i.e. the immovable property, and the country where it is located. This connection is regarded so strong that the right to tax of the source state has priority over the right to tax of any other state, even if the income is only indirectly derived from immovable property.³⁵⁷ Exclusive source state taxa-

³⁵⁷ Commentary to Article 6 of the OECD Model Tax Convention, Paragraph 4.

tion of income from immovable property is undisputed and relatively straight forward to apply. It generally should not cause issues in respect of immovable property used for activities covered by a CCA. This would only be different in the exceptional situation that the terms and conditions of a CCA provide for profits from immovable property to effectively be shared among participants. This could for example be the case, if a cost shared laboratory is on a part time basis rented out to a third party and the rental income is taken into account as a negative cost when valuing the local participant's contribution under the CCA. To avoid discussions with tax authorities it is recommendable for MNEs to structure their CCAs so that any foreseeable and unforeseeable income from immovable property used in the course of cost shared activities is exclusively allocated to the legal owner of such property. This can be achieved by not sharing income from immovable property, such as rental income and capital gains, with other participants. At the same time the CCA should foresee in a fixed arm's length compensation for the owner for making the immovable property available to the participants community. That is materially different from simply sharing all costs associated with that property including its depreciation. The former approach should be defensible from a transfer pricing point of view, as third parties normally also include an appropriate amount for housing costs in their charges to customers while keeping risks and opportunities associated with immovable property separated from day-to-day business transactions.

8.5. Conclusions

The key findings of this Chapter 8 are as follows,

In respect of the possibility that participation in a CCA results in a foreign permanent establishment:

- (i) A participation in a CCA should by itself not cause a permanent establishment abroad. The main reason for this is that the position of a CCA participant making resources available or performing activities under a CCA is in respect of critical elements comparable to that of an intra-group service provider. Crucially the other participants do not have unrestricted access to the facilities of the first participant and the other participants can therefore not be considered to have a fixed place of business in the country of residence of that first participant.
- (ii) To avoid confusion, I have written a proposed text confirming this interpretation to be included in the Commentary to Article 5 of the OECD Model Tax

Convention. This would make it clear beyond a doubt that, if tax administrations feel the outcome of a CCA is such that they are not able to tax a fair share of results given the value created in their jurisdiction, they would have to seek a transfer pricing adjustment.

In respect of withholding tax on balancing payments:

- (i) A tax sharing approach allowing for source state taxation of gross payments under a CCA implies a risk of an excessively high tax rate being applied to the included net profit element and is therefore preferably avoided. However, there are a number of instances in which international tax law currently does provide for source state withholding tax on balancing payments.
- (ii) To the extent that balancing payments are a compensation for access to pre-existing intangible property, while the effective ownership of such intangible property does not transfer, they should be labeled as royalty and can, as such, suffer source state withholding tax subject to the provision of the source state's national law and any applicable tax treaty. The joint development of new intangibles however is materially different from making intangibles available for use. Balancing payments in respect of development activities should therefore not be qualified as royalties, unless the payer does not receive a proportionate share of the effective ownership in the new intangibles. If so, balancing payments may be qualified as royalties and subjected to royalty withholding tax in accordance with domestic law of the source state and any applicable tax treaty.
- (iii) Irrespective of the foregoing, balancing payments in respect of development activities and services provided under a CCA can be subject to withholding tax, if the national law of the source state imposes such tax and that state has reserved a right to tax income from providing services to its residents in its tax treaties. As illustrated by the Indian M/s. C. U. Inspections case, a critical aspect to take into account can then be whether or not the balancing payment includes a profit element. Under the new Chapter VIII of the OECD Transfer Pricing Guidelines this will more generally be so. To the extent that the recipient is then located in a country with which the source state has concluded a tax treaty, such country should live up to its treaty obligation and allow for relief from double taxation.

In respect of the potential foreign tax liability from the use of immovable property under a CCA:

- (i) There should be no foreign tax liability of participants from the use of immovable property, provided that the contribution of its use by the legal owner is valued at a fixed arm's length amount and all other economic up- and downside risk associated with the property in fact remains with its legal owner exclusively.

9. CFC Rules

9.1. Introduction

As already acknowledged in the previous chapter, states will in principle only tax profits of their residents and (under certain circumstances) of non-residents, which are in some way connected to their territory.³⁵⁸ This system can offer the opportunity to MNEs to limit their total tax cost by allocating to controlled subsidiaries in low tax jurisdictions highly mobile concepts like the ownership of certain income generating assets, for example intangibles, or the assumption of risk, for example development risk under a CCA. To prevent the use of structures lacking economic rationale, some countries have introduced targeted anti-avoidance rules aimed at including the income of controlled foreign companies ("CFCs") in the taxable income of their domestic parent. This Chapter 8 first looks at the background of such CFC rules (Paragraph 8.2). It then analyzes their relation to transfer pricing issues (Paragraph 8.3.1) and subsequently considers how they might help prevent the use of CCAs in base erosion and profit shifting structures (Paragraph 8.3.2).

9.2. Background of CFC Rules

9.2.1. Balancing Export Neutrality and Competitiveness

The United States was the first country to introduce CFC rules. Operating a worldwide tax system, the US traditionally uses the so called credit method to avoid double taxation. Under this system US companies are taxable on worldwide income. They are then provided a tax credit for the foreign tax on that income. Since 1 January 2018 a major exception applies for foreign dividends. Those are now fully exempt at the level of the US parent, while the US continues

³⁵⁸ They may for example tax business profits attributable to a local permanent establishment of a foreign company (see Paragraph 8.2) or passive income like dividends, interest or royalties originating from their jurisdiction (see Paragraph 8.3). Unilateral measures or tax treaties will then generally foresee in relief from double taxation through an exemption or a tax credit in the residence state of the recipient of the income.

to tax its residents' other income on a worldwide basis.³⁵⁹ To the extent the foreign tax rate is lower than the US tax rate the total tax charge on the latter income is effectively "*topped up*" to the US rate. Hence, the taxpayer would pay tax at the highest of either the foreign tax rate or the US tax rate. By consequence, from the perspective of a US taxpayer an investment opportunity in the US should *ceteris paribus* not be less attractive than an investment opportunity in a low tax jurisdiction. As such, the US tax system is considered to establish capital export neutrality.

At the same time the characteristics of these systems led to concerns about the competitiveness of domestic companies investing abroad. As the US tax rate was relatively high, especially during fiscal years before 2018, US multinationals operating outside their home country would generally pay more tax than their local competitors and consequently they would be left with less profit to reinvest. Before it introduced an exemption on foreign dividends the US compensated for this by not taxing all foreign sourced business income immediately. Instead they generally allowed for a deferral of taxation until the income was actually repatriated to the US parent. If income was reinvested abroad, the term of the deferral could be quite long. This of course resulted in taxpayers realizing a lower effective tax rate on foreign income than on domestic income. By consequence, the deferral allowance was in fact a limitation on the principle of export neutrality and opens up arbitrage opportunities. The introduction of CFC rules by the US in 1962 can be regarded an attempt to strike a balance between the principle of capital export neutrality and the concerns about the competitiveness of US multinationals. For this purpose certain types of income, referred to as "*Subpart F income*"³⁶⁰ are excluded from the deferral mechanism and instead included in taxable income at the level of the parent company at the same time they arise with the subsidiary

In later years many other countries followed the US example and also introduced CFC rules in their national tax laws. Contrary to the US, most of these countries operate a territorial tax system. That means that they in principle only impose tax on their residents' local income and allow for an exemption of their foreign income. Under a territorial system the tax on foreign business income is effectively limited to the tax imposed by the source state. This places taxpayers investing abroad at par with their local competitors. For that reason the exemption method is considered to result in capital import neutrality. Although this

359 Public Law no. 115-97, "*Act to provide for reconciliation pursuant to titles II and V of the current resolution on the budget for fiscal year 2018*" ("*2017 US Tax Reform Act*").

360 These rules are laid down in the Internal Revenue Code, Chapter 1, Subchapter N, Part III, Subpart F.

can obviously be considered a stimulus for taxpayers with the ambition to invest abroad, it can at the same time offer an incentive for taxpayers to allocate mobile income to subsidiaries in low tax jurisdictions. To avoid tax avoidance the application of the exemption method is therefore generally restricted to active business income. A credit method is then used to provide relief from double taxation in respect of passive income. Such an approach is often supplemented by CFC rules, which under certain conditions directly include the passive income in the taxable profit of the parent company, so that the domestic taxation cannot be excessively deferred by retaining the income in a foreign subsidiary.

9.2.2. Design and Compatibility with Tax Treaties

Traditionally there is considerable variation in how countries have structured their CFC rules. They use different definitions of “control”. They also distinguish in their own way between the types of income that are covered and at how low a rate that income should be taxed for the rules to apply. Furthermore, there are two fundamentally different approaches for including a CFC’s income in the taxable base at the level of the parent company. Under the “*look-through approach*” the CFC is regarded tax transparent and its income is considered the own income of the parent company. Under the “*deemed dividend approach*” on the other hand the income is assumed to be paid by the CFC to the parent company as a dividend, regardless of whether such payment has actually taken place. The distinction between the look-through and deemed dividend approach can be relevant when establishing whether CFC rules are compatible with tax treaties. This has been the subject of dispute in several countries.³⁶¹ Taxpayers argued that CFC rules following the look-through approach should under Article 7 of the OECD Model Tax Convention not apply to business profits. Similarly CFC rules following the deemed-dividend approach would be considered a breach of Article 10, paragraph 5. Some tax courts ruled in favor of taxpayers, others in favor of tax administrations³⁶². The OECD however included language in the Commentary to Article 1, 7 and 10 of the Model Tax Convention to clarify that it does not consider CFC rules to constitute a treaty override. Taking into account the purpose of CFC rules as an anti-abuse measure, I wholeheartedly agree with this position.

³⁶¹ See Lang, Aigner, Scheuerle and Stefaner 2004, General Report, section III and M. Heidenreich in Simander, Titz et al 2013, Paragraph 3.3.

³⁶² The Court of Appeals for England and Wales ruled in favor of the tax administration (Bricom Holdings Ltd. v. Inland Revenue, 25 July 1997, 70 TC 272), while the French Conseil d’Etat ruled in favor of the taxpayer (Société Schneider Electric, 28 June 2002, No. 2322764).

9.3. CFC Rules and CCAs

9.3.1. Introduction

Multinationals in search of a long term tax deferral or exemption can use different techniques in order to increase the amount of profits allocated to low taxed group companies. For a good understanding of how CCAs can play a role in this, it should be acknowledged that there is a conceptual difference between, on the one hand, shifting profits to low taxed group companies through transfer pricing manipulation (*"the transfer pricing manipulation technique"*) and, on the other hand, shifting profits to low taxed group companies by preemptively allocating the ownership of the assets generating those profits (*"the preemptive reallocation of ownership technique"*). A more or less similar distinction is also made by Kane, who refers to the first technique as *"milking"* and the second technique as *"parking"*.³⁶³ The difference can be further clarified by considering the example of a company located in a high tax jurisdiction that is a member of a multinational group. Its domestic R&D team develops a high value technology, of which the company becomes the legal and effective owner. If it subsequently allows other foreign group companies located in low tax jurisdictions to exploit the intangible in exchange for a royalty that is below market price, this multinational group would be applying the transfer pricing manipulation technique. Alternatively the group could try to apply the preemptive reallocation of ownership technique. In that case the group would look to allocate the ownership of the technology to a low taxed subsidiary that would then license it out to the various group companies making use of it for purposes of their business operations. The high taxed company could for example transfer the ownership of the technology to the low taxed affiliate in an early stage of its development, when it is not yet certain how successful that development will be and the transferee would be taking on a certain amount of development risk. Under such circumstances the transfer could take place at a relatively low value. CCAs can further facilitate and in fact enhance this technique, because they allow the joint development of the intangible together with a low taxed affiliate. Provided that such affiliate has sufficient substance to argue that it controlled the risks associated with the cost shared activities, it would share in the full development risk, obtain the effective co-ownership of that intangible right from the very moment that it comes into existence and a transfer as well as the realization of a potentially taxable capital gain by the transferor would be avoided altogether. In other words the tax benefit would be fully optimized, as the maximum amount of

³⁶³ Kane, Tax Law Review 2013, page 478 – 506.

future returns would be shifted to the low taxed affiliates at the lowest possible price.

It should be noted that transfer pricing manipulation is in breach of rules and regulations. As explained extensively in Chapter 3, transfer prices should cohere to the ALS. This is the common international standard and as such incorporated into most national tax systems. If the rules and regulations of those systems would be successful at achieving their objectives, there would be no shifting of profit through transfer pricing manipulation. However, the problem is that the principle based ALS is to some extent arbitrary and can in practice be difficult to apply, specifically for tax administrations lacking specialist insight in the business environment in which an intangible is developed and exploited. By consequence, there is a continued risk of intentional or unintentional “*transfer mispricing*” and a backstop to the rules can be useful. CFC legislation may play that part.³⁶⁴ The role of CFC legislation is somewhat different when it comes to tax avoidance using the preemptive reallocation of ownership technique. Contrary to transfer pricing manipulation a preemptive reallocation of ownership, either under a CCA, through a sale or via any other transaction, can very well be fully compliant with all applicable tax laws. The taxpayer would just be optimizing its benefit from the tax deferral or exemption of profits in foreign subsidiaries allowed by its state of residence to safeguard the competitiveness of that state’s “*own*” multinationals abroad. Intended or not, such deferral or exemption has opened up a completely legal arbitrage opportunity. CFC legislation may limit this by including the profit from the re-allocated assets in the taxable income of the parent company. In that case CFC rules should in my opinion be considered as a tool to balance between capital import and export neutrality. In that role they are not a backstop, but instead a primary line of defense against undesirable tax avoidance.

9.3.2. Including Intangible Returns in CFC Income

9.3.2.1. The Obama Administration’s Proposal

As explained in Paragraph 4.3 the US Treasury and IRS have been trying to counter the preemptive reallocation of ownership technique by requiring high buy-in payments for access to cost sharing arrangements. However, as experienced by the IRS in the Veritas and Amazon case, this is significantly complicated

³⁶⁴ Note that the OECD regards the qualification of CFC rules as a “*backstop*” misleading, because both transfer pricing rules and CFC rules target distinct categories of income. Although those may sometimes overlap, each set of rules has its own right of existence (see: OECD/G20, “*Designing Effective Controlled Foreign Company Rules*”, 5 October 2015, page 14).

by the complex valuation exercises that then have to be performed. Preparing financial projections on which to base such valuation is difficult, specifically for tax administrations that will generally have less insider's knowledge about intercompany transactions than taxpayers. Solving this with retroactive adjustments to the buy-in payment after considering ex post results is under pressure, as it could entail an undesirable use of hindsight (see Paragraph 4.3.3.3 and 5.5.3.2). As an alternative, it may be considered to reverse the profit shift by means of the preemptive transfer of ownership technique not through a higher buy-in payment, but by instead including future profits in the taxable income of the parent at the time those profits materialize.

The suggested alternative solution would involve including "excessive" income of cost shared intangibles in CFC income and tax such return at the level of the parent company. Revenue provisions along these lines were consistently suggested by the Obama administration in the US budget proposals for each fiscal year since 2011.³⁶⁵ If under the proposal a US taxpayer would transfer an intangible from the US to a CFC, then any income from transactions connected with or benefitting from that intangible exceeding the cost properly allocated and apportioned to this income increased by a percentage mark-up, i.e. the excessive income, would be included in the US parent's taxable Subpart F income. The administrative draft further specified that income would be considered excessive, if it exceeds 150% of the costs attributable to that income. In other words, the percentage mark-up would be fixed at 50%. All of the excessive income subject to an effective tax rate of 10% or less would be regarded low taxed and become directly taxable with the US parent company. In addition a gradual phase out of the new rules would be allowed for income subject to an effective tax rate of 10 to 15%. Income taxed at a rate of 15% or higher would not be affected by the new rules. In other words, if a US parent transfers an intangible to its controlled foreign subsidiary, which in return makes a payment of 100 to the US parent, then any return of the foreign subsidiary exceeding 150 would be considered excess profit. To the extent those profits are then not subject to at least 15% tax in the foreign subsidiary's state of residence, the US would include a part or all of that excess profit in the taxable income of the US parent.

It is explicitly stated that the proposal also covers income from intangibles of which the ownership rights were allocated through "*a shared risk or development agreement (including any cost sharing arrangement)*". In my opinion this refers to pre-existing intangibles contributed as a platform contribution and not

³⁶⁵ Budget of the United States Government, Fiscal Year 2011, Office of Management and Budget, www.budget.gov.

to intangibles newly developed under a CCA. That reading corresponds with the analysis of the proposal by the US Joint Committee on Taxation. This analysis establishes that “*transfers made in conjunction with cost-sharing arrangements present a unique issue*” and continues to clarify that these transfers often concern platform intangibles, used for the development of a next generation of intangible assets.³⁶⁶ The Joint Committee on Taxation also explains that if the CCA allows the participants community to use the US owned technical know-how on the manufacturing of a certain product for further development, the income from exploitation of version 2.0 of that product will be part of income “*connected with or benefitting from*” the transfer of that know-how and thus be taken into account when determining whether returns can be considered excessive. It does however not become clear whether this mechanism continues, when later generations (version 3.0 and so forth) are developed and exploited. In my opinion this matter is very similar to the issue around useful lifespan encountered when valuing platform contributions. However, as it is not a transfer pricing rule but an anti-abuse rule that is proposed here, the matter could in this instance be settled by further explicating in the legislative provision itself or in its context that the proposal also covers income from next generation intangibles of which the development was facilitated by the transfer or contribution of a platform intangible. In that case the measure would go one step further than just being a backstop to transfer pricing rules. It would in fact give the jurisdiction of the parent company the ability to include in its taxable base a part of the income of next generation intangibles developed under a CCA.

9.3.2.2. *The OECD Recommendations*

The possibility to include excess profits in CFC income has also been considered by the OECD. This resulted in the inclusion of a separate section on the matter in the Report about the design of CFC rules, which was published as part of the 2015 final BEPS deliverables.³⁶⁷ The report sanctions rules that characterize income in excess of a “*normal return*” earned in low tax jurisdictions as CFC income. The normal return is calculated as a percentage of eligible equity, which is defined as the equity invested in assets used in the active conduct of a trade or business, including intangible assets. According to the OECD Report economic studies have shown that a normal return on such equity would be 8% to 10%, although this varies by industry, leverage and jurisdiction. The report acknowledges that including excess profits in CFC income may be specifically useful in respect of

³⁶⁶ US Joint Committee on Taxation, “*Description of Revenue Provisions Contained in the President’s Fiscal Year 2013 Budget Proposal*”, June 2012.

³⁶⁷ OECD/G20, “*Designing Effective Controlled Foreign Company Rules*”, 5 October 2015, page 49.

income from intangibles. At the same time it also recognizes that an excess profits approach is fundamentally different from currently existing CFC legislation, because it would include all income above the threshold without further classification. It will not be necessary to determine where, from whom or from which activities the income was earned. As such the working of this approach could be regarded quite mechanical, which raises concerns about suitability and accuracy. These concerns may be countered however by a substance-based exclusion. Such exclusion is not described extensively by the OECD, but may be understood to exclude returns that were caused by conditions that could not have reasonably been foreseen when the intangible was transferred or contributed. Furthermore, it should be remembered that an inclusion in CFC income does not result in double taxation. As long as the tax paid on the income abroad is creditable, it merely results in a top-up of the effective tax rate on the income to the tax rate of the parent company's jurisdiction of residence. This of course significantly limits the negative effects of the presumed inaccuracy.

9.3.2.3. 2017 US Tax Reform

While the Obama administration's proposal never made it into law, an alternative measure aimed at including intangible returns of CFCs in the taxable income of their US parent was adopted as part of the 2017 US Tax Reform Act.³⁶⁸ This introduced the concept of so called Global Intangible Low Taxed Income ("GILTI"), which consists of any of the CFC's earnings above a routine 10% on its tangible business assets. The US parent is allowed a fixed 50% deduction of such income, but the remainder is then subject to US corporate income tax at a rate of 21%, thus resulting in an effective tax rate of 10.5% on the GILTI. Subsequently the taxpayer is granted a tax credit for 80% of the foreign income tax already paid on the income. On balance that means that there will be no additional US income tax due on the income, if it is subject to at least 13.125% abroad. This can be illustrated by the example of a US parent with a controlled foreign subsidiary that owns 400 of tangible business assets and 1,000 of intangible business assets. If its earnings in a year are 140, the CFC's routine return is calculated at 40 (10% of 400 tangible business assets), leaving a GILTI of 100. After the fixed deduction of 50%, an amount of 50 is regarded the US parent's taxable income. At a rate of 21% the maximum US tax on this is 10.5, i.e. 10.5% of taxpayer's total GILTI. However, if the income is already subject to foreign income tax in the hands of the CFC, then 80% of such tax is creditable. That implies that no additional US tax is payable, if the foreign income tax is equal to at least 13.125%

³⁶⁸ HR 1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97.

or more. It should be mentioned that the fixed deduction is envisaged to go down to 37.5% of the GILTI for fiscal years starting after 31 December 2025. This implies that from then on the foreign income needs to be equal to at least 16.4% for there to be no additional US taxation. Furthermore, it can be added that the 2017 Tax Reform Act as a mirroring image to the GILTI taxation also introduced a new regime for foreign derived intangible income ("*FDII*"), which provides for excess returns of US companies from foreign sales, licenses and leases, to effectively be taxable at a reduced rate of 13.125% as from 1 January 2018, increasing to 16.4% as from 2026.

9.3.3. Author's Analysis

As already acknowledged in Paragraph 1.4 the mobile nature of intangible assets poses a difficult issue for tax administrations trying to prevent MNEs from eroding their domestic tax base. They can attempt to counter this by more strictly upholding transfer pricing rules and regulations. If they are successful at that, they will counter transfer pricing manipulation. However, that leaves open certain arbitration opportunities offered to MNEs by the possibility to preemptively reallocate the ownership of high value intangibles to low taxed subsidiaries, for example by jointly developing those assets under a CCA. As such, I understand the incentive to try to tax excessive returns of low taxed affiliates from intercompany transactions involving intangible assets. Again the US appears to be the pioneering country first to adopt a new specific anti-abuse measure. It can be argued that the formula based GILTI regime is somewhat rough around the edges. For one, there is no direct link to the US required in respect of the intangibles generating the taxpayer's GILTI. This means that even income derived from assets that were developed and owned exclusively outside of the US are in scope and can thus be taxed in the US. However, when considered more carefully it can be looked upon as simply consistent with the US' worldwide tax system. Second, the GILTI regime does not foresee a substance-based exclusion, as suggested by the OECD. Hence, the taxpayer cannot avoid the GILTI taxation by evidencing a certain level of substance in its CFCs. It can be argued that increased substance in the CFCs will generally cause the CFCs to own more business assets and thus to have a higher routine return, which in turn should reduce the GILTI. At the same time, that will not be the case if the substance consists of employees rather than tangible assets, while the former type of substance may still justify some relief. Third, an apparently fundamental flaw of the GILTI regime is that despite its broad scope and mechanical working it allows only an 80% credit for foreign income tax. This causes double taxation in respect of the non-creditable 20%, even in potentially bona fide situa-

tions. At the time of writing, the administrative regulations further specifying the GILTI regime still have to be published and its effectiveness in daily fiscal practice has not been proven yet. Nevertheless, the GILTI regime potentially makes a reallocation of intangible assets by a US parent to its low taxed CFC far less attractive, while the simultaneous lowering of the effective tax rate on FDII further removes the incentive to do so. If it turns out a successful disincentive for preemptive asset reallocations, the US approach can be expected to be replicated by tax administrations across the globe.

9.4. Conclusions

The key findings of this Chapter 10 are as follows,

In respect of the traditional purpose and working of CFC rules:

- (i) CFC rules are generally intended to strike a balance between offering domestic MNEs a good competitive position on the international stage by allowing a deferral or exemption of foreign sourced income and avoiding arbitrage.
- (ii) CFC legislation, if properly drafted, is compatible with tax treaties based on the OECD Model Tax Convention and, as such, should not be considered to constitute a treaty override.

In respect of the effectiveness of CFC rules to prevent tax avoidance structures involving CCAs:

- (i) Tax avoidance structures involving CCAs can be split in two categories: One is aimed at manipulating transfer prices, the other at preemptively reallocating the ownership of valuable assets, most notably intangibles, to low tax jurisdiction.
- (ii) The solution for transfer pricing manipulation should in first instance come from enhanced transfer pricing rules. Only if those are unsuccessful, CFC rules can act as a backstop.
- (iii) When it comes to a preemptive reallocation of ownership or in fact the preemptive sharing of ownership of valuable intangibles under a CCA, transfer pricing solutions involve complicated valuation exercises and will therefore always leave room for arbitrary decisions, discussions and

disputes. The inclusion of excess returns from intangibles in CFC income, like is the case under the US GILTI regime, could potentially keep taxpayers from initiating such reallocation. It might be specifically effective, if combined with a reduced domestic tax rate on intangible income, as under the US FDII or a European style patent box regime.

10. Upfront Certainty and Dispute Resolution

10.1. Introduction

As the determination of the correct transfer pricing and tax treatment of CCAs can be a complex exercise, it may lead to uncertainty, disputes and, consequently, double taxation. International tax law offers different instruments to avoid or resolve issues. It provides for possibilities to obtain upfront certainty from tax administrations about the tax or transfer pricing treatment of a certain position or transaction. It also enables procedures to effectively resolve disputes. However, neither of those instruments is always appropriately tailored to effectively tackle situations involving a CCA. This Chapter 10 first considers the possibility to obtain upfront certainty about transactions under a CCA from one or more tax administrations in a tax ruling or advance pricing agreement (Paragraph 10.2) and subsequently examines the available dispute resolution procedures under modern day tax treaties (Paragraph 10.3). In both instances a critical analysis of the existing mechanisms with a focus on their applicability in respect of CCAs is accompanied by recommendations for improvements.

10.2. Upfront Certainty

10.2.1. Advance Pricing Agreements

With complex transactions as those under a CCA it can be in the interest of both taxpayers and tax authorities to operate a system under which taxpayers can obtain upfront certainty. For taxpayers this offers clarity about their fiscal position before they enter into transactions, while it mitigates the risk of adjustments, penalties and double taxation. For tax administrations it limits auditing costs, avoids future disputes with other countries and increases insight in business circumstances as well as common pricing policies. A decision on upfront certainty is generally formalized as a tax ruling or, when it concerns transfer pricing matters, as an advance pricing agreement ("APA"). A tax ruling addresses the interpretation and thus the application of tax law in a specific

case. Having taken into account the facts and circumstances presented to them, the tax authorities formalize their decision in the ruling, which is then provided to the taxpayer. An APA on the other hand has a slightly different nature. It is a contract between taxpayer and tax authorities on the acceptability of transfer pricing policies and application of the arm's length principle to the case at hand. The OECD provides relevant guidance on APAs in section F of Chapter IV of the OECD Transfer Pricing Guidelines as well as in the Annex to that Chapter IV. That includes the following definition of an APA:

*"An advance pricing agreement ('APA') is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time."*³⁶⁹

An APA is not necessarily concluded by a taxpayer with a single tax administration. It can also be concluded with two administrations (a bilateral APA) or more than two administrations (a multilateral APA). According to the OECD *"the bilateral (or multilateral) approach is far more likely to ensure that the arrangements will reduce the risk of double taxation, will be equitable to all tax administrations and taxpayers involved, and will provide greater certainty to the taxpayers concerned"*.³⁷⁰ This is specifically applicable in respect of transactions under CCAs, because those might often involve participants from multiple countries. The terms and conditions of the contractual arrangement will then affect the taxable profit in each of those jurisdictions. The only way to rule out any risk of future disputes would be for all tax administrations involved to sign off on the APA. However, tax administrations are not in all countries allowed to enter into binding agreements with taxpayers directly. In that case, the mutual agreement procedure under an applicable tax treaty may offer the alternative solution of an agreement between the competent authorities of such country and the treaty partner. It should be noted that in that case the taxpayer is not a party to the agreement. However, under Article 25 of the OECD Model Tax Convention, the taxpayer does play a crucial role, as he has to initiate the mutual agreement procedure through a formal request.

Specifically in the field of transfer pricing, the number of requests for upfront certainty has increased significantly over recent years. A logical explanation for this is that the existing transfer pricing legislation leans strongly on the discretionary norms of the ALS rather than that it provides a set of detailed prede-

³⁶⁹ OECD Transfer Pricing Guidelines, Paragraph 4.132.

³⁷⁰ Idem, Paragraph 4.139.

terminated rules. As such, establishing the open market price for a transaction between related parties is by nature an arbitrary matter. It involves not only the identification, but also a subjective appraisal of facts and circumstances of the case at hand. The latter leaves a certain room for “*negotiations*” between tax administrations and taxpayers about what pricing is appropriate. Where it has so far simply not been possible to develop a more rule based way of determining transfer prices, APAs are an alternative way to provide taxpayers with legal security. They may also be regarded a pragmatic tool allowing for tailor-made solutions to regulate transfer pricing issues on a case-by-case basis. This was also recognized in a 2011 study by Markham on the experience with APAs in particularly the US and Australia.³⁷¹ Among others she interviewed transfer pricing experts from both jurisdictions about their experience with APAs. These experts pointed out the general push for increased transparency and the need to share information upfront with tax administrations anyway. They flagged the relevance of upfront certainty due to increased audit attention for transfer pricing matters as well as more stringent financial reporting standards. Furthermore, they considered that an APA application offers access to the best experts in the tax administration. The interviewees considered the expensive and time-consuming application process and its bureaucratization as the greatest disadvantage of using APAs. However, offset against the administrative burden of preparing transfer pricing documentation, handling audits and domestic dispute resolutions these disadvantages did not appear to outweigh the benefits offered by APAs.³⁷²

At the same time critics of the tax ruling and the APA system argue that the individualized approach of case-by-case agreements may cause this system not to comply with the principles of legality and equality.³⁷³ They point out that in a democratic society taxation should be based on duly established laws. If this is not the case, there is in their opinion a risk that larger, more influential MNEs will be able to negotiate better deals than smaller, less wealthy taxpayers. These concerns may be justified and will grow, as tax rulings and APAs are kept strictly confidential. If no or only very limited information on their contents is made available to the general public, there is a lack of transparency and a limited control of state actions. That this may have a competition distorting effect has also been acknowledged by the European Commission. Although the Commission does not oppose tax rulings and APAs in general, it has considered several

371 Markham 2012.

372 See Markam 2012, Chapter 4 and also compare Kerschner and Stiastny, Intertax 2013/11.

373 M. Toribio Leao, International Transfer Pricing Journal 2014/4.

tested examples to constitute state aid and therefore be in breach of European regulations in relation to APAs concluded by individual companies.³⁷⁴

10.2.2. Proposal for a Standard for APA Requests Concerning a CCA

There are valid concerns about the use of CCAs in base erosion and profit shifting structures. This is rightfully addressed in the BEPS project by adding control over risk as a precondition for group companies to participate in a CCA and by requiring that more contributions are valued at market price rather than at cost. However, while that may limit abuse of the arrangement for tax avoidance purposes, it also makes structuring, operating and auditing CCAs significantly more complex. Furthermore, it was established in Chapter 8 that there may be discussions about whether or not operating a CCA can lead to a foreign tax liability of participants. Therefore, I believe that an increased demand for upfront certainty in respect of transactions under a CCA is a logical development. Facilitating such demand would avoid costly audits and, potentially, disputes between taxpayers and tax administrations as well as between tax administrations among each other. Concerns about a lack of transparency and a consequential illegality or inequality can be substantially mitigated by requiring the contents of tax rulings and APAs to be shared with other tax administrations. That would generally discourage overly beneficial arrangements, as those are more likely to be neutralized by increased taxation in other countries or, in an EU context, would trigger state aid allegations. For bilateral or multilateral arrangements such backstops apply automatically, while for tax rulings and unilateral APAs this could be achieved by improved processes for international exchange of information. That political consensus on these matters is realistic has been proven among others by the agreement on the automatic exchange of information concerning cross-border tax rulings and APAs reached by EU Member States in 2015.³⁷⁵

In light of the foregoing there is in my opinion a strong case to make for embracing APAs as a solution to problems posed by the principle based approach to transfer pricing under the ALS. When CCAs are concerned, the preferred scenario involves multilateral APAs to which the tax administrations from at least the most relevant countries involved are a party. The OECD also

374 Examples are the APAs concluded between carmaker Fiat and the Luxemburg tax administration and between coffee retailer Starbucks and the Netherlands tax administration (press release of the European Commission of 21 October 2015) as well as the Belgium so called excess profit ruling regime (press release of the European Commission of 11 January 2016).

375 Council directive (EU) of 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, Official Journal of the EU, L332, 18 December 2015.

recognizes this and mentions the use of APAs for transactions under a CCA specifically in Paragraph 4.140 of the Transfer Pricing Guidelines:

"Tax administrations may find APAs particularly useful in profit allocation or income attribution issues arising in the context of [...] and also] handling multilateral cost contribution arrangements."

Be that how it may, negotiations of APAs between more than two tax administrations or competent authorities can of course be a complex and cumbersome exercise. This makes it even more relevant that taxpayers include the right information in the APA request or the request to start up a mutual agreement procedure. The OECD words it as follows:

*"The cooperation of the associated enterprises is vital to a successful APA negotiation. For example, the associated enterprises ordinarily would be expected to provide the tax administrations with the methodology that they consider most reasonable under the particular facts and circumstances. The associated enterprises also should submit documentation supporting the reasonableness of their proposal, which would include, for example, data relating to the industry, markets, and countries to be covered by the agreement. In addition, the associated enterprises may identify uncontrolled businesses that are comparable or similar to the associated enterprises' businesses in terms of the economic activities performed and the transfer pricing conditions, e.g. economic costs and risks incurred, and perform a functional analysis as described in Chapter 1 of these Guidelines."*³⁷⁶

The information included in the request should allow for an adequate assessment of the financial and commercial relations between the participants in the CCA and an accurate delineation of the transactions between them under that arrangement. I would advocate that it should also allow the tax administrations or competent authorities to categorize the CCA under the categorization model of Paragraph 2.3.3.2. In my opinion the description of facts and circumstances to be included in the APA request could be quite adequately structured along the lines of the main transfer pricing focus areas identified in Paragraph 5.1:

- *General information* – To set the scene for the analysis to follow, the request should include company specific details relevant to determine the group's

376 OECD Transfer Pricing Guidelines, Paragraph 4.133.

overall financial and commercial position as well as background on the industry in which the group operates and the market positions that it has been able to assume. It would also appear logical that the introductory section of the request explains when and for what general purpose the CCA was concluded.

- *Description of Activities (including functions performed, risks assumed and assets used)* – The request should continue to provide a description of the nature of the activities performed under the CCA, indicating their relative importance and complexity. It should indicate which employees will perform those activities, elaborating on their job level and skill set. Further, it should identify the most relevant tangible or intangible pre-existing business assets used in the process, either to perform the activities or to serve as a platform asset for the development of a completely new asset, explaining the purpose of use and most unique characteristics of these assets. Furthermore, the request should describe and, if possible, quantify the risks associated with the activities performed under the CCA. It should also exhaustively list and describe the results that are anticipated to come from the activities performed under the CCA and the benefits those results are anticipated to offer. To the extent that the activities are expected to result in the creation of new tangible or intangible assets, the nature and use of those assets in the market on which the taxpayer operates should be described, allowing the tax administration or competent authorities to understand their role in the group's value chain.
- *Identification of Participants* – The request should further identify all participants to the CCA and subsequently include information about the financial position of each of them. That should evidence that each participant has sufficient financial resources to bear their share of costs associated with the activities performed under the CCA as well as risks, were they to materialize. The request should also provide a clear outline of how the group is organizationally set up and, consequently, what each participant's involvement in the performance of the cost shared activities is. This should include a description of the substance of the participants, referencing which personnel they employ that is involved in the coordination or day-to-day performance of activities covered by the CCA and which assets they own that are used for the performance of those activities. As a minimum, it should be made clear why each participant has sufficient capacity and authority to control the risks associated with the activities performed under

the CCA and how it regularly uses that capacity and authority to actually exercise such control.

- *Division of Benefits* – The request should clearly and unambiguously lay out how the anticipated benefits from activities performed under the CCA as well as any additional unforeseen benefits from those activities are divided up among participants in a perpetual, non-overlapping and exclusive manner, for example on a territorial or field-of-use basis. Among others it should confirm how the effective ownership of newly developed assets is shared among participants and how each of them has unlimited access to its proportionate share of results free of any charges in addition to their contributions under the CCA.
- *Valuation of Contributions* – The request should build on the other information provided to provide a comprehensive overview of all contributions in kind made under the CCA split per contributing participant. It should subsequently describe how these contributions are valued and why the selected valuation method is regarded to result in arm's length pricing. It should identify the valuation method used per type of contribution and reference any back-up documentation available evidencing its appropriateness, including most notably any information that may be available in respect of comparable open market transactions. If any contributions are valued at cost, the request should elaborate on why that is the case and explain how the difference between market and cost price was either already included in the valuation of a pre-existing contribution or such difference is limited and cost is in fact a practical means to determine the relative value of the contributions. Furthermore, if the CCA contract includes a retroactive adjustment mechanism for when actual benefits deviate significantly from anticipated benefits, then such mechanism should be referenced here. If on the other hand the contract does not include an adjustment mechanism, it should be explicitly requested that the tax administration or competent authorities agree with and accept the risk assumption under the CCA contract. That would imply that no adjustments will be made for any deviation of actual benefits from anticipated benefits unless there is a breach of any critical assumptions, upon which the APA is made conditional (see Paragraph 10.2.3).
- *Calculation of Balancing Payments* – The request should then describe how the balancing payments are calculated, so that they arrange for the partici-

pants' proportionate share of overall contributions to be consistent to their proportionate share of overall expected benefits. This involves an explanation of how the participants' proportionate share of overall expected benefits is determined. To the extent that this is done using a key, it should be explained which objectively verifiable measures serve as the basis for this key and why those are considered to appropriately reflect the participants' relative share of the overall expected benefits. Furthermore, if applicable, the request should include a description of the adjustment mechanism that allows for a prospective adjustment of the allocation method in case of changed economic, financial or operational circumstances.

- *Conclusions in respect of tax and transfer pricing treatment* – Finally the request should draw conclusions from all facts and circumstances presented about the tax and transfer pricing treatment of the transactions under the CCA and thereby summarize exactly what the tax administration or competent authorities are signing off on. First and foremost, it would be the intent to acknowledge that the terms and conditions of the transactions under the CCA do not differ from what independent enterprises would have agreed under similar circumstances, that the CCA therefore complies with the arm's length principle and that, by consequence, the arrangement leads to an appropriate allocation of income between these group companies for purpose of calculating their respective income tax liabilities in the countries of which the tax administrations or competent authorities are a party to the APA. Furthermore, there could be value in determining that there will be no foreign tax liability of group companies from their participation in the CCA or in specifying which balancing payment qualifying as royalties or services can be subjected to source state withholding taxation and at what rate.
- *Appendices* – Obviously the request should be accompanied by any relevant back-up documentation that may be available. Most notably however the CCA contract and the group's transfer pricing master file appear standard documents to be attached.

In Paragraph 38 of the Annex to Chapter IV of the Transfer Pricing Guidelines the OECD points out that:

"The content of the proposal and the extent of the necessary supporting information and documentation will depend on the facts and circumstance

of each case and the requirements of the individual participating tax administrations. It is therefore not considered practicable to list or define exactly what should be provided."

The EUJTPF in its "Guidelines for Advance Pricing Agreements" concluded along the same lines, but nevertheless made an attempt to include some general instructions for composing an APA request in two appendixes to its Report. Although one may agree that it is not possible to prescribe the specific information that is to be provided for every transaction, I still believe that standardization of APA requests covering a specific type of transactions can accommodate fiscal practice and lead to more successful negotiations between taxpayers and tax administrations or between competent authorities. In respect of transactions under a CCA for example, the OECD could include guidance as an annex to Chapter VIII of the Transfer Pricing Guidelines and I would think the above could serve as a good starting point for drafting such annexure.

10.2.3. Critical Assumptions

A major complexity of APAs is that they aim to qualify the pricing of transactions that will only take place in the future. Whether the pricing methodology agreed upon is then still appropriate can depend on certain facts and circumstances as they stand at that point in time. This can require so called "*critical assumptions*" about those facts and circumstances to be included in the agreement. The OECD also recognized the importance of such critical assumptions and pays special attention to them in section C.3.6 of the Annex to Chapter IV of the Transfer Pricing Guidelines. Paragraph 43 of the Annex states:

"... The assumptions are defined as 'critical' if the actual conditions existing at the time the transactions occur could diverge from those that were assumed to exist, to the extent that the ability of the methodology reliably to reflect arm's length pricing is undermined..."

Which critical assumptions are to be determined depends on the type of transactions, the applied transfer pricing methodology, the individual circumstances of the taxpayer and the commercial environment in which the taxpayer operates. The OECD promotes basing them on observable, reliable and independent data. Examples are assumptions about domestic tax law and treaty provisions, assumptions about tariffs and other import or export regulations, assumptions about economic, commercial and financial conditions and assumptions about the taxpayer's organization.

As has also been recognized in fiscal literature, the instrument of critical assumptions can be applied extensively or restrictively.³⁷⁷ An extensive application could entail the use of many different critical assumptions or broadly worded assumptions. A restrictive use would be more focused and would involve the use of only a limited number of critical assumptions, which have a narrowly defined scope of application. An extensive application of critical assumptions makes the agreement more specific, better acceptable to tax administrations and therefore easier to negotiate. However, it also makes the agreement less reliable, thus eroding its purpose of providing upfront certainty. In the US the IRS has provided guidelines to avoid problems with critical assumptions.³⁷⁸ First, these prescribe to make critical assumptions extreme outer limits, so that they would only lead to cancelation of the APA under extraordinary circumstances. Second, they recommend making the assumptions objective, in the meaning that they should be specific. If for example a decrease of sales numbers is considered a critical assumption, it should be included with what percentage sales should drop instead of only indicating that sales should drop “*substantially*”. Third and finally, the guidelines consider adjustment clauses in the legal contract underlying the transaction preferable to critical assumptions in the APA. As such, it can be argued that the IRS has adopted a relatively restrictive application approach. When it comes to concluding an APA for transactions under a CCA, I would also be in favor of maintaining effectiveness of the agreement by only restrictively applying critical assumptions. For one, it would be preferable that the CCA contract provides for a retrospective adjustment clause in respect of the valuation of pre-existing intangibles, which can then be referenced in the APA, rather than that the binding nature of the APA is made depended on a critical assumption about the result from the exploitation of those intangibles by individual participants. Similarly, it would offer more upfront certainty to all parties involved, if the participants to the CCA contractually agree a prospective adjustment of the applied cost allocation key, instead of making the applicability of the APA subject to the key’s measure staying within a specified range. At the same time that does not mean that there is no room for critical assumptions at all or that those that are included would not be fundamentally important for the APA. The in my opinion most obvious critical assumption to include regards the organizational set-up of the taxpayer’s group. This is closely related to the categorization of the CCA for transfer pricing purposes under the categorization model of Paragraph 2.3.3.2. A change in the level of centralization, which is

³⁷⁷ Carolis, Intertax 2013/12.

³⁷⁸ US IRS, “*APA Study Guide Lesson One: Major Elements*”, available at https://www.irs.gov/pub/irs-apa/apa_study_guide_.pdf.

not uncommon within large MNEs, can dramatically impact the relative value of each participant's contribution under the CCA and thus require that the applied transfer pricing methodology is adjusted. Furthermore, it may be appropriate to include critical assumptions in respect of elements external of the transactions covered on a case-by-case basis. For example a change in relevant domestic tax law or applicable tax treaties and a dramatic change in market circumstances might still offer a valid reason for early termination of the agreement.

10.3. Dispute Resolution

10.3.1. Introduction

The OECD, UN and US model tax conventions all include a procedure to resolve disputes, in case the actions of a contracting state result in taxation that is not in accordance with the provisions of the convention. This is intended to ensure that tax treaties are applied correctly and that they succeed in their aim of avoiding double taxation. In the OECD Model Tax Convention the procedure is provided for by Article 25 and consists of a two-step approach. The first step is laid down in Paragraph 1 to 4 of Article 25 and is referred to as the mutual agreement procedure ("*MAP*"). It allows taxpayers to present their case to the designated representatives ("*competent authorities*") of their state of residence, if they are able to demonstrate that actions by one or both of the contracting states in breach of the treaty have led to economic and/or juridical double taxation. These competent authorities then have to endeavor to reach agreement about a suitable solution, removing the double taxation, with the competent authorities of the other contracting state. It is important to note that the competent authorities have a so called best-efforts obligation only. That means they have to do their best to reach an agreement, which at least entails a duty to negotiate. It is however not mandatory that they actually reach such an agreement.³⁷⁹ Under the OECD Model Tax Convention an MAP has to be initiated within three years of the first notification of the action by a contracting state that is not in accordance with the tax treaty. It can be positioned regardless of whether domestic remedies have been pursued up to the last resort. In practice however competent authorities have proven reluctant to enter into negotiations with their counterparts in the other contracting state as long as domestic appeals are pending. If the competent authorities of the contracting states are unable to reach an agreement within two years, Paragraph 5 of Article 25 of the OECD Model Tax Convention provides for the second step of the dispute resolu-

379 Commentary on Article 25 of the OECD Model Tax Convention, Paragraph 37.

tion procedure. This makes it possible for taxpayers to request unresolved issues to be submitted for arbitration before a committee of experts. However, if the competent authorities have already reached a mutual agreement that sufficiently eliminates double taxation, taxpayers cannot bring issues to arbitration only because they believe the outcome of such agreement is incorrect. In other words: Arbitration is not an alternative or additional resource for taxpayers that do not agree with the outcome of an MAP.

It should be acknowledged that the two step dispute resolution procedure provided for by the model tax conventions is non-mandatory. That means that countries are not obliged to include it in their tax treaties and in practice many countries have not done so or included only the possibility of a MAP without the backstop of arbitration. In a positive development however, dispute resolution received a push by its recognition under the BEPS-project as a necessary balancing measure next to anti-avoidance rules.³⁸⁰ Additionally, on 10 October 2017 the European Council adopted a directive on tax dispute resolution mechanisms, which prescribes that all Member States should either on a unilateral basis or by means of an MAP resolve the dispute resulting in double taxation or alternatively enter into binding arbitration. The new directive has a more extensive scope than the EU-Arbitration Convention, as it also covers non-transfer pricing disputes. Furthermore, a taxpayer can challenge non-compliance of Member States in respect of the directive with the European Court of Justice, while the ECJ in principle does not have jurisdiction to interpret and enforce the provisions of the Arbitration Convention.

10.3.2. Disadvantages of Traditional Dispute Resolution Procedures

The non-binding and non-mandatory nature of the traditional dispute resolution procedures makes that tax treaties are not always successful at avoiding double taxation. Besides this, there is more criticism of these procedures. In his thesis published in 2005, Altman identifies various other fundamental disadvantages.³⁸¹ He considers that current procedures inadequately address the inequality between negotiating tax administrations. Such inequality may lead to inappropriate outcomes and may for example occur when developing countries have to negotiate with developed countries, on which they depend for trade and capital investments. In addition Altman highlights that the outcome of MAPs and arbitration proceedings are in many countries not binding on the domestic courts. They also do not generate guidance to others nor establish a system of precedence, as long as the agreements are kept confidential. Further-

³⁸⁰ OECD/G20, "Making Dispute Resolution Mechanisms More Effective", 5 October 2015.

³⁸¹ Altman 2006.

more, tax administrations can apply stalling techniques, if in fact they do want to resolve a case in a timely manner. All this leads Altman to suggest alternative dispute resolution procedures with binding arbitration by an independent International Tax Tribunal under supervision of a Global Tax Organization. Although there is a lot to say in favor of this proposal, there is unfortunately no sign of any political intention to move in that direction now or in the foreseeable future. By consequence it remains a theoretical alternative, mostly interesting from an academic perspective only.

A further issue with the traditional dispute resolution procedures that deserves specific attention is that they focus on bilateral solutions and, by consequence, are often times ineffective in situations involving more than two countries. This can become specifically apparent, if a transfer pricing adjustment is made in respect of transactions under a CCA. If the CCA includes participants from more than two countries, such adjustment will impact the tax position of the group in the same number of jurisdictions. Consider for example a multinational group with a Dutch parent and several foreign subsidiaries that sets out to develop a new manufacturing technology under a CCA. Although all participants exercise control over the risks associated with the cost shared activities, most of the day-to-day R&D work is provided in a limited number of locations, among which a laboratory in The Netherlands. For the purpose of calculating balancing payments under the CCA, the group may decide to value these activities on a cost plus basis. Now assume that upon audit the Dutch tax administration disagrees with this valuation. It argues that in comparable uncontrolled transactions the unique skill set and expertise of R&D personnel is better remunerated and that the contribution made by the Dutch participant should be valued at a significantly higher amount. The Dutch tax administration then adjusts the taxable profit of the Dutch participant accordingly. In that case, to effectively avoid double taxation the group would have to seek a corresponding adjustment in the countries of residence of all other CCA participants.

A similar, although not specifically CCA related issue recognized in fiscal literature concerns the problems posed by so called triangular cases.³⁸² That issue is referenced here, because the solution for it may be the same as the solution for the problems with CCA related dispute resolution. Triangular cases involve a transfer pricing adjustment in one state that is neutralized by a corresponding adjustment in another state, but also inspires the tax administration of the other state to make a new transfer pricing adjustment in respect of a related yet different intercompany transaction with an associated enterprise in a third

³⁸² Van Herksen, *Intertax* 2008/8-9, Vollebregt, *International Transfer Pricing Journal* 2012/2 and R. Biçer, *International Transfer Pricing Journal* 2014/2.

state. Vollebregt illustrates this by the example of a taxpayer that is a resident of a non-EU parent with a subsidiary in a first EU member state ("EU1"), which in turn holds subsidiaries in several other EU member states ("EU2", "EU3" etc.).³⁸³ The non-EU parent sells to EU1, which is the sole European inventory company and sells to the bottom tier EU subsidiaries, which are distributors, shortly before they sell to customers. As all the technology and brands are developed and owned by the non-EU parent, the applied transfer prices allows that parent to earn all residual profit, while the functions performed and risks assumed by the different EU companies are such that those companies earn only a fixed margin. If the resident state of a bottom tier EU company considers the profit of its resident to be insufficient, it may adjust its resident's taxable profit by assuming a lower purchase price for products bought from EU1. A corresponding adjustment would erode the margin earned by EU1 and therefore may trigger a second transfer price adjustment, this time in the resident state of EU1 in respect of the purchase price paid to the non-EU parent. This would result, as Vollebregt puts it, in "*a carousel of mutual agreement procedures*".

It should be noted that the EUJTP has also addressed triangular cases.³⁸⁴ It considers three different solutions. The first involves a prospective resolution through (multilateral) advance pricing agreements. Second, it suggests interpreting Paragraph 3 of Article 25 of the OECD Model Tax Convention to provide for a multilateral approach to eliminating double taxation. Third, the EUJTPF considers that the working of the Arbitration Convention may be extended to third states based on Article 35 and 36 of the Vienna Convention on the Law of Treaties assuming acceptance of such rights or obligations by the third state.³⁸⁵ However, none of the three solutions is investigated in much detail. Nevertheless the EUJTPF in its Report on Non-EU Triangular cases concludes that it "*has taken the discussion as far as it is possible*".

³⁸³ See Vollebregt, International Transfer Pricing Journal 2012/2.

³⁸⁴ EUJTPF, "Report on Non-EU Triangular Cases", JTPF/007/REV2/2009/EN (January 2010).

³⁸⁵ Article 35 of the Vienna Convention on the Law of Treaties states: "*An obligation arises for a third State from a provision of a treaty if the parties to the treaty intend the provision to be the means of establishing the obligation and the third State expressly accepts that obligation in writing.*"

Article 36 of the Vienna Convention on the Law of Treaties subsequently states: "*A right arises for a third State from a provision of a treaty if the parties to the treaty intend the provision to accord that right either to the third State, or to a group of States to which it belongs, or to all States, and the third State assents thereto. Its assent shall be presumed so long as the contrary is not indicated, unless the treaty otherwise provides. A State exercising a right in accordance with paragraph 1 shall comply with the conditions for this exercise provided for in the treaty or established in conformity with the treaty.*"

10.3.3. Proposal for Simultaneous or Multilateral Mutual Agreement Procedures

Over the years the OECD has made several attempts to improve the effectiveness and accessibility of the dispute resolution procedure. Next to the extensive commentary on Article 25 a Manual on Effective Mutual Agreement Procedures ("MEMAP") was published.³⁸⁶ Furthermore, as part of the BEPS project a minimum standard with respect to the resolution of treaty-related disputes was developed and participating countries declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties. However, none of these publications includes wording on multilateral dispute resolution or the specific issues that may arise in respect of CCAs and this can be considered a missed opportunity.

I believe that the existing dispute resolution procedures could be improved so that a consistent transfer pricing treatment of individual CCAs by all countries involved is better safeguarded. For this purpose I would advocate including the following paragraph to Article 25 of the OECD Model Tax Convention:

"Where, under Paragraph 1, a person has presented a case to a competent authority that involves a Contracting State including in the profits of an enterprise of that State profits on which an enterprise of the other Contracting State as well as an enterprise of a Non-Contracting State have directly or indirectly been charged to tax in those States, then that competent authority will, in addition to any attempt of resolving the case by mutual agreement with the competent authority of the other Contracting State under Paragraph 2, endeavor to resolve the case by mutual agreement with the competent authority of the Non-Contracting State. The competent authority of the other Contracting State will make any reasonable effort possible to facilitate such mutual agreement is reached, which may include an endeavor to resolve the case through a multilateral agreement."

The proposed wording would allow for both simultaneous mutual agreement procedures and multilateral procedures. Explicitly mentioning that profits may also be indirectly subject to tax in a third state is intended to expand the scope to transfer pricing disputes that may require a corresponding adjustment in more than one jurisdiction, including the triangular cases mentioned in Paragraph 10.3.2. Obviously there is no obligation for the non-contracting state to coop-

³⁸⁶ The manual is available at <http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreement-procedures-index.htm>.

erate. Next to that, the contracting states may in fact regard profit adjustments in the relationship with such non-contracting states to be outside the scope of their tax treaty. For this reason the proposed additional paragraph should probably be non-mandatory. Furthermore, it would of course be strange to make the obligation to resolve double taxation in respect of non-contracting states more stringent than the obligation to do so in respect of the two contracting states themselves. Therefore, the proposed obligation under the additional paragraph is limited to the same best-efforts obligation to “*endeavor*” to resolve the case with the competent authorities of the non-contracting state. Still contracting states may be hesitant to expand the working of the treaty to third states. However, in my opinion it can then be emphasized that it is in the interest of each of the contracting states to ensure a reciprocal commitment on the consistent treatment of intercompany transactions in which their residents participate, including intercompany transactions under a CCA. After all, having to pursue a group wide solution requires the other contracting state to more carefully consider the validity of its position, which will force it to refrain from incautious adjustments. That already serves a purpose as such. At the same time it may also to some extent address Altman’s concern about potential inequality between states that are caught up in a mutual agreement procedure. Under the proposed amended Article 25 an economically powerful state could no longer “*bully*” a politically dependent state into an inappropriate adjustment without at least also having to defend the basis for such adjustment in front of other states that individually or together might be better positioned to oppose the first state. Finally, from the perspective of a state that wants to initiate an adjustment it can be helpful to be assured of the assistance of the other contracting state in mutual agreement procedures with third states. If that enables the first state to show that the proposed adjustment is accepted elsewhere, it would improve its position in negotiations with the competent authorities of such third states and, by consequence, allow it to better defend its own taxable base while protecting its residence against double taxation.

10.4. Conclusions

The key findings of this Chapter 10 are as follows,

In respect of procedures to obtain upfront certainty:

- (i) Irrespective of how confident taxpayers may be about the arm's length nature of their CCAs and the flawlessness of their documentation, the principle based approach inherent to the ALS makes that there will be a subjective element to any transfer pricing assessment. That in turn leaves room for discussions, uncertainty and, ultimately, disputes. APAs offer a potential solution for these issues.
- (ii) An APA request for transactions under a CCA should include a broad range of information in respect of each of the five transfer pricing focus areas as identified in Paragraph 10.2.2. Fiscal practice would benefit, if a standard confirming this would be included as an annex to Chapter VIII of the OECD Transfer Pricing Guidelines.

In respect of procedures for dispute resolution:

- (i) Traditional dispute resolution procedures have so far proven ineffective in respect of disputes involving CCAs because of their non-binding and non-mandatory nature as well as their bilateral orientation.
- (ii) To promote a more consistent transfer pricing treatment of intercompany transactions, including those under a CCA, an obligation should be included in Article 25 of the OECD Model Tax Convention for a contracting state that wishes to make a profit adjustment to, upon request from the taxpayer enter into a mutual agreement procedure not only with the competent authorities of the other contracting state, but also with the competent authorities of non-contracting state affected by such adjustment.

Part 4: Conclusions

11. Conclusions and Recommendations

11.1. Introduction

This study set out to examine the tax aspects of CCAs. To structure the analysis Paragraph 1.5 determined 7 research objectives. Subsequently Chapters 2 to 9 outlined a theoretical framework, first by considering the general concept of CCAs and the application of these arrangements in practice, then by investigating the transfer pricing aspects and the international tax law treatment of CCAs. This Chapter 11 summarizes my conclusions and recommendations per research objective. Paragraph 11.2 looks at the history of rules and regulations and how the thinking about CCAs by legislators and policymakers developed over the years. Paragraph 11.3 discusses the legitimate reasons for use of the arrangements and their role in tax avoidance structures. The then following two paragraphs outline the most relevant transfer pricing aspects: Paragraph 11.4 compares the US Cost Sharing Regulations with the relevant OECD guidance, while Paragraph 11.5 presents a 10-step plan to implement an arm's length CCA. This is accompanied by a model legal contract. Further, Paragraph 11.6 considers the potential of a foreign tax liability as a consequence of participating in a CCA, after which Paragraph 11.7 and 11.8 include recommended improvements to CFC rules and procedures for advance certainty and dispute resolution. Finally, Paragraph 11.9 provides some closing remarks.

11.2. Historical Background

Research objective (i):

To examine the historical background and original purpose of CCAs and to establish how the conceptual thinking about these arrangements as a legitimate transfer pricing instrument and a tax avoidance tool evolved over the years.

The CCAs defined in Chapter 1 concern arrangements under which participants share costs and risk on the basis of their anticipated benefits and subsequently exploit results on an individual basis. This type of arrangement is mostly concluded between companies that belong to the same multinational group.

Its workings in terms of costs, risks and benefits allocation differ materially from the joint development agreements found between unrelated third parties, under which participants share costs and risk on a predetermined basis and then exploit results on a joint basis while allocating the benefits from the exploitation in proportion to each other's cost contributions. By consequence there is a general lack of comparable uncontrolled arrangements against which the arm's length nature of controlled CCAs can be tested. However, as discussed in Paragraph 2.2.1, that does not mean that CCAs cannot qualify as a legitimate transfer pricing instrument. The reason for this is that the difference between CCAs and uncontrolled joint development arrangements can be explained by the specific circumstances under which related parties operate, specifically the absence of the normal conflict of interest that would have existed between independent parties. As such, CCAs have for more than half a century been recognized as a legitimate method to arrange for the joint development, production or obtaining of tangible and intangible business assets as well as services.

The original purpose for the introduction of the bona fide cost sharing arrangements by the United States Treasury was to accommodate taxpayers. If the intangibles were developed under a qualifying cost sharing arrangement they would be co-owned by all participants and there would be no need to transfer or license out the intangibles to other group companies. This would avoid complex valuation issues. The OECD subsequently followed to adopt the concept of a CCA in its first transfer pricing reports. At that time it did not consider CCAs to be a tax avoidance tool. To the contrary, in Paragraph 109 of its 1979 Report the OECD chose to explicitly reference the US' experience that *"no greater danger of tax avoidance is seen through cost sharing arrangements than through any other type of intra-group transaction"*. Furthermore, it stands out that none of the early guidance explicitly required participants in the arrangements to have a minimal amount of substance. This was interpreted in practice to allow cash box entities in low tax jurisdictions access to the valuable group intangibles developed under the arrangement. In respect of another crucial element, the valuation of contributions, the US Treasury and the OECD expressed a difference of opinion. While the former allowed a valuation at cost, the latter was in favor of including a profit element and, in other words, advocated a valuation at market price. However, when the 1995 Transfer Pricing Guidelines came out the OECD softened its position and included ambiguous wording indicating only that further guidance on the valuation of contributions at cost or at market price might still be necessary. After that, during the more than 20 years it was considered defensible to value contributions at cost. This was then also argued to apply to high value adding contributions, such as the performance of development activities performed

by uniquely skilled and experienced R&D teams. It was only in the 2015 Final BEPS Report that the OECD finally published guidance to the contrary. By now a serious concern about the use of CCA in tax avoidance structures had developed and a full review of the dedicated Chapter VIII of the Transfer Pricing Guidelines was initiated. Addressing both the substance of participants and the valuation of contributions the new guidance required participants to have the capacity to control risks associated with the cost shared activities and to value contributions at market price.

11.3. Legitimate Use and Tax Avoidance

Research objective (ii):

To identify the legitimate business reasons for the use of CCAs, to determine the role of these arrangements in tax avoidance structures and to propose a categorization model that can facilitate a tax and transfer pricing analysis of their application in practice.

In Paragraph 2.3.1 four legitimate business benefits were identified to stem from the operation of a CCA. The arrangement facilitates a free flow of expertise and knowledge, allows for cross company risk sharing, brings contractual simplicity and offers upfront certainty and consistency in respect of the group's transfer pricing approach. These non-tax driven benefits of use further justify that CCAs are recognized as a legitimate transfer pricing instrument. Nevertheless, it is commonly acknowledged that the arrangements are also used in tax avoidance structures. This is illustrated among others by the examples provided in the Report of the US Joint Committee on Taxation of 2010 and the OECD's Base Analysis Report on Base Erosion and Profit Shifting of 2013. These show that the two critical elements of CCAs that facilitate their use in tax avoidance structures are:

- (i) the participation of low substance group companies, specifically when cash box entities participate, and
- (ii) the undervaluation of contributions in kind, specifically when specialized development activities are valued at cost.

Both these elements offer MNEs an opportunity to allocate taxable profits stemming from their most valuable intangible business assets to group companies located in low tax jurisdictions. This is not effectively neutralized by the current anti-abuse rules or by source state withholding taxation. It is therefore

logical that legislators and other policymakers are trying to better regulate the use of CCAs. However, it has to be recognized that the application in aggressive tax planning structures is not per definition illegal. Distinguishing between legitimate use and tax avoidance is therefore an arbitrary exercise, without any legal consequence. At the same time assessing the appropriateness of the use of a CCA can help to identify those situations, in which there is an increased risk of tax avoidance and additional attention should be paid to the terms and conditions of the arrangement in order to determine its correct tax and transfer pricing treatment. In Paragraph 2.3.3.2 a categorization model was presented that in my opinion can facilitate such assessment. This model considers the taxpayer’s organizational set-up and the nature of the developed intangibles to then divide up CCAs into four quartiles. CCAs used to grant group companies access to centrally developed, innovative intangibles are assumed more likely to feature low substance participants or undervalued contributions and therefore end up in the high-risk quartile. Those are the arrangements that should be targeted by tax and transfer pricing rules and regulations and which on an individual basis should be most carefully monitored by tax practitioners.

11.4. US Cost Sharing Regulations vs. OECD Transfer Pricing Guidelines

Research objective (iii):

To analyze the applicable transfer pricing rules and regulations governing CCAs as well as relevant case law, focusing primarily on the US Cost Sharing Regulations and OECD Transfer Pricing Guidelines.

The current US Cost Sharing Regulations and OECD Transfer Pricing Guidelines use distinct terminology and on occasion show differing opinions as to how a CCA can comply with the ALS. These differences are summarized per focus area in the following table:

	US Cost Sharing Regulations ("CSR")	OECD Transfer Pricing Guidelines ("TPG")
Terminology		
General	The CSR refer to cost sharing arrangements or "CSAs".	The TPG refer to cost contribution arrangements or "CCAs".
Contributions of pre-existing resources	Making pre-existing resources available under a CSA is referred to as a " <i>platform contribution</i> ".	Making pre-existing resources available under a CCA is referred to as a " <i>pre-existing contribution</i> ".
Contributions to ongoing cost shared activities	Making a contributions to ongoing cost shared activities is referred to as a " <i>cost contribution</i> ".	Making contributions to ongoing cost shared activities is referred to as a " <i>current contribution</i> ".
Costs settlement	Cost settlements are referred to as " <i>platform contribution transactions</i> " and " <i>cost contribution transactions</i> ".	Cost settlements are referred to as " <i>balancing payments</i> ".
Activities		
Development activities	Both the CSR and TPG regard development activities suitable for cost sharing.	
Services	Regarded suitable for cost sharing, although the CSR focus predominantly on development activities	Regarded suitable for cost sharing.
Participants		
Mutual benefit	Both the CSR and TPG require all participants to anticipate a benefit from their participation in the CSA/CCA that consists of more than just a cash compensation for their contributions.	
Substance requirement	The CSR do not explicitly impose any material substance requirements for participants.	Participants should have the capacity to control the risk associated with the cost shared activities and regularly exercise such control.
Benefits		
Territorial allocation	A territorial allocation of benefits is explicitly allowed, provided that participants receive the perpetual, non-overlapping and exclusive right to exploit the cost shared results through the use, consumption, or disposition of property or services in their appointed territories	No explicit guidance provided, but a territorial allocation of benefits is implicitly allowed.
Field of use allocation	A field of use based allocation of benefits is allowed, provided that participant should receive the perpetual, non-overlapping and exclusive rights to exploit the cost sharing results through their appointed field of use.	No explicit guidance provided, but a field of use based allocation of benefits is implicitly allowed.

	US Cost Sharing Regulations ("CSR")	OECD Transfer Pricing Guidelines ("TPG")
Alternative allocation	Any alternative allocation is allowed, provided that the interest in cost shared results is clearly and unambiguously divided among participants, recordkeeping enables the checking of a consistent application, the participants' exploitation rights are perpetual, non-overlapping and exclusive and it is possible to predict with a reasonable reliability the resulting benefits per participant.	No specific guidance provided, but any reasonable alternative allocation of benefits is implicitly allowed.
Contributions		
Valuation of pre-existing resources	Platform contributions are valued at market price, which should in the opinion of the Treasury and IRS reflect the value of any ex ante commitment to make resources available at cost during the course of the CSA.	Pre-existing contributions are valued at market price.
Ex post adjustments	The CSR allow the commissioner to make retroactive adjustments on the basis of ex post results, unless those results are the consequence of extraordinary events that could not reasonably have been anticipated. The CSR provide a safe haven rule, under which no adjustment will be made, if the participants' returns stay within a predefined range of return ratios.	The TPG allow tax authorities to make retroactive adjustments on the basis of ex post results, unless those results are the consequence of extraordinary events that could not reasonably have been anticipated. The TPG provide a safe haven rule, under which no adjustment will be made, if the adjustment is less than 20% of the total value of the transaction.
Valuation of the performance of ongoing cost shared activities	Cost contributions are valued at cost.	Current contributions are valued at market price, unless (a) the value of the ex-ante commitment to make resources available at cost during the course of the CCA is already reflected in the valuation of a pre-existing contribution or (b) the difference between cost and market price is minimal and cost can be regarded an appropriate means to determine the relative value of current contributions.
Balancing payments		
Allocation of costs	Both the CSR and TPG allow for direct cost allocations based on projected results as well as indirect cost allocations based on an appropriate allocation key (e.g. number of employees, production volumes and sales).	
Periodic Adjustments	Both the CSR and TPG require periodic reassessment of contributions vis-à-vis the revised share of benefits, potentially resulting in an appropriate prospective adjustment.	

What stands out is the discrepancy in the US and OECD approach regarding the participation of low substance group companies and the valuation of contributions, the two critical elements that potentially make CCAs an effective tax avoidance tool. The US tax administration allows access to CSAs for cash box entities and accepts a valuation of the performance of ongoing cost shared activities at cost. It relies on its ability to recoup future taxable profits by enforcing a high buy-in payment. For that purpose it attempts to qualify the ex-ante commitment to make high value resources available at cost during the course of a CSA as a platform contribution, which is to be appropriately compensated at the outset of the arrangement. However, the IRS has so far not been successful in defending this position in court (see Paragraphs 4.3.4 to 4.3.6). The now available case law concerned fiscal years that were governed by old Cost Sharing Regulations and the IRS might be more successful, if next time it litigates under the current regulations. The decisions in the Veritas and Amazon case however provide for some technical concerns about the IRS's position. First of all, the applied broad definition of platform contributions assumes the existence of concepts that represent value and that are capable of being transferred between group companies, which have not been recognized as business assets before. These items would include goodwill, going concern value and a workforce in place, but such items are beyond the intangibles definition provided in the Internal Revenue Code. Secondly, the IRS advocates an aggregated valuation of the pre-existing resources constituting a platform contribution. This can be regarded as extremely complex, if not impossible, given that the useful life of those resources can vary significantly. Thirdly, the IRS approach conflicts with the original reason of Congress to sanction the use of bona fide CSAs, which was to avoid valuation issues.

The OECD favors different methods in respect of both critical elements. The Transfer Pricing Guidelines exclude those group companies from participation that do not have sufficient substance to control the risk associated with the cost shared activities (see Paragraph 5.3.2) and, at least as a main rule, value current contributions at market price instead of at cost, so that participants are generally compensated for the actual performance of functions during the course of a CCA instead of for an ex ante commitment to make available certain resources (see Paragraph 5.5.3). I am strongly in favor of the OECD's approach compared to that of the US tax administration. First of all, it is in my opinion reasonable to consider the commercial and financial relations between related parties to differ from the legal contracts in place between them, if one of the parties does not have the capacity and resources to control the risk that it has contractually assumed. As such, a mere cash box entity cannot actually share risk under

a CCA. However, as the sharing of costs and risks is the sheer essence of the arrangement, such cash box entity cannot participate in it at all. Secondly, while the US approach of requiring a high buy-in payment and then valuing further contributions at cost is overly complex, the OECD's main rule of valuing all individual contributions at market price at least has the benefit of segregating the valuation of pre-existing assets from that of the performance of cost shared activities. As such, the OECD's main rule isolates separately transferred "*hard*" platform intangibles from not transferred "*soft*" intangibles impacting the value of functions performed under the CCA. As such, it allows for a better identification of the subject of the valuation exercise and items such as a workforce in place are more accurately recognized as what they actually are: Not an intangible transferred at the outset of the CCA, but a comparability factor impacting the value of the functions performed by an individual participant. That way the already quite complex valuation of pre-existing contributions is not further complicated, while the valuation of current contributions can be established using traditional transfer pricing methods - potentially an appropriate comparable uncontrolled price can be found or, depending on facts and circumstances, a cost plus or profit split method could be applied.

11.5. An Arm's Length CCA

Research objective (iv):

To develop a step plan and a model legal contract facilitating the implementation of an arm's length CCA.

11.5.1. Step Plan

The outcome of the recent initiatives to counter base erosion and profit shifting is expected to have a major impact on international tax law and the overall fiscal environment. With transfer pricing and specifically the tax treatment of intangibles at the center of the debate, these developments will also impact the rules and regulations governing CCAs. That will complicate the design of new arrangements and the testing of existing ones. To facilitate these processes it can be helpful to translate the guidance provided by the US Cost Sharing Regulations and the OECD Transfer Pricing Guidelines into the following comprehensive 10-step plan for establishing an arm's length CCA:

1. The activities that are the subject of the CCA are to be identified. Under a development CCA there should be actual new development activities performed. Merely granting access to pre-existing intangibles should be

structured as a transfer or license arrangement instead of a CCA. That also implies that the development activities have to be material. The maintenance of existing intangibles or the making of only marginal improvements to existing intangibles seems insufficient. Furthermore, shareholders activities, duplicative activities and activities providing no or only an incidental benefit to other group companies should be excluded.

2. When selecting participants it is to be confirmed that each of them expects a benefit from their own individual exploitation of results. This benefit should therefore exceed a mere cash compensation for rendering services to the participants' community and therefore low risk service providers are excluded. Only group companies that will exploit the cost shared results themselves are allowed access to the CCA.
3. It should be established that each participant has the capacity to control the risk associated with the cost shared activities and actually exercises such control. That means that each participant should have sufficiently skilled personnel to make decisions about entering into the CCA or terminating its participation in the arrangement, about the direction and scope of the cost shared activities and about the available budget.
4. The effective and legal ownership of expected results has to be clearly and unambiguously assigned to individual participants, if possible on an exclusive and non-overlapping basis.
5. The pre-existing contributions, most notably the contributed platform intangibles, have to be identified and a valuation method has to be specified taking into account the guidance from Chapter VI of the OECD Transfer Pricing Guidelines and, from a US perspective, the commensurate-with-income standard of Section 482 of the Internal Revenue Code (see Paragraph 4.2.1).
6. The current contributions have to be identified and an appropriate valuation method has to be specified.
7. A methodology for calculating balancing payments has to be agreed. This should result in the overall contribution of participants to be proportionate to their expected benefits, allowing for prospective adjustments to such methodology in case of changes in the scope of the cost shared activities,

the business operations of participants or economic, commercial and financial circumstances.

8. The taxpayer may consider including a clause allowing for retrospective adjustments to the valuation of pre-existing contributions. Although such a clause can be structured in any way that is compatible with the ALS, it would appear logical for it to be based on the model for periodic adjustments under §1.482-7(i)(6) of the US Cost Sharing Regulations (see Paragraph 4.3.3.3.1) or the model for the use of ex post results in respect of hard to value intangibles under Paragraph 6.193 of the OECD Transfer Pricing Guidelines (see Paragraph 5.5.3.2.4).
9. If it is intended to license out intangibles resulting from cost shared activities to controlled or non-controlled third parties, the legal owners should be granted the authority to do so under the condition that proceeds are shared with all participants in proportion to their share in the effective ownership of such intangibles.
10. Finally, the admittance or departure of participants as well as the termination of the CCA should be addressed. It should be clearly stipulated that an appropriate arm's length payment is made, if any such event leads to a transfer of ownership of cost shared results.

Working through each of these steps, it is useful to carefully consider the position of the transactions at hand under the categorization model of Paragraph 2.3.3.2. Such consideration can also serve the purpose of an overall sanity check as to whether a CCA is the most appropriate legal arrangement for structuring those transactions. Most notably, if the taxpayer is a highly centralized group developing innovative and high value intangibles in a limited number of locations, i.e. the taxpayer is high up in the north-eastern quartile of the categorization model, then it may be considered that the commercial position and bargaining power of the R&D and marketing centers is such that the economical outcome of the CCA should be identical to that under a licensing model. The latter could then be found the better alternative, for example if it is easier to benchmark an arm's length royalty rate than to value CCA contributions.

To illustrate how this step plan can be applied in practice, the fictitious company X Electronics, introduced in Paragraph 1.3, can be used as a case study. It has three categories of activities in respect of which its group companies wish to enter into a CCA. These consist of the group's strategic marketing effort, the

group's research and development activities and the group's executive management and support services. These activities can be accurately identified and are collectively referred to as the global activities (**Step 1 of the Step Plan**). Before formalizing the CCA, it further has to be established whether each of the potential participants expects a benefit from those activities and whether the size of such benefit is in proportion to functions performed and assets used (**Step 2 of the Step Plan**). Strategic marketing and R&D will result in valuable intangible assets. This might for example involve brands, trade names, manufacturing technology and product know-how. As such, these two categories of global activities qualify as development activities. In respect of the strategic R&D and marketing it is apparent that they result in valuable intangible assets with relevance for the business operations of all participants performing the primary business activities manufacturing and sales. Under these circumstances it can be concluded that there is sufficient mutual benefit of participants to structure these activities in a CCA. The executive management and support services are centralized in X US and X UK. In respect of these activities there is also a reasonable expectation of benefit for all participants, including X US and X UK themselves. If the latter would not be true, it could still be defensible to include the services, if it could be ensured that the outcome of the arrangement is arm's length by valuing the services with reasonable accuracy at market price. A further precondition for establishing an arm's length CCA is that all potential participants should have the capacity to control the risks associated with the global activities (**Step 3 of the Step Plan**). As discussed in Paragraph 5.3.2.6 the net effect of this requirement is that cash box entities are excluded from participation. The X group however does not include any cash box entities. While the global marketing strategy is coordinated by X UK and the fundamental R&D is centralized in X Singapore, local distribution and manufacturing companies also contribute to these activities. Each of those companies houses active business operations and will employ sufficiently skilled personnel, which can and will take decisions about entering into or terminating its participation in the CCA, the direction and scope of global activities and the available budget. Each of them is therefore a legitimate CCA participant. By consequence the group can continue to draft a CCA contract.

11.5.2. Model CCA Contract

Having clearly identified the activities performed and the qualifying participants to the arrangement, the X group can continue to draft a CCA contract as attached (see Annex - "*Model CCA Contract*"). The further elaboration on the steps 4 to 10 of the step plan should be read in close conjunction with this Model

CCA Contract and vice versa. In that contract it is assumed that the results of the global activities consist of marketing and R&D intangibles as well as services. Whereas services may by their nature provide specific benefits to individual participants, the allocation of the effective ownership of intangibles may require some additional specification (**Step 4 of the Step Plan**). This could be achieved by granting each of the participants the exclusive right to use marketing intangibles for third party sales on their own domestic markets and wider geographical regions, while allowing them to use research and development intangibles for all manufacturing activities at their own production sites (**Article 2 of the Model CCA Contract**).

Subsequently the different contributions of each of the participants are to be identified and assigned an appropriate valuation method (**Step 5 and 6 of the Step Plan / Article 3 and 4 of the Model CCA Contract**). Pre-existing contributions can consist of tangible and intangible assets used to perform global activities. It may also concern platform intangibles, which are further developed under the CCA to create new, more advanced marketing or R&D intangibles. These contributions should be valued at market price. In respect of pre-existing intangibles the value might be determined by applying the relief-from-royalty method, which would involve calculating the net present value of a hypothetical royalty stream during the useful life of the intangibles (see Paragraph 5.5.3.2.3). For the support services a cost plus remuneration might be a reasonable solution. In practice an illustrative list of contributions, their value and valuation method can be added as an appendix to the contract, while in respect of more complex contributions the group will be expected to supplement its transfer pricing documentation by a detailed valuation report potentially supplemented by benchmark studies.

The identification and valuation of contributions is followed by their allocation to participants, which allocation is then effectuated through balancing payments (**Step 7 of the Step Plan / Article 5 of the Model CCA Contract**). In this case X Electronics has determined that third party sales are an appropriate allocation key for contributions related to strategic marketing and production costs for contributions related to research and development (**Article 6 and 7 of the Model CCA Contract**). The contributions related to executive management and support services on the other hand are allocated on the basis of time spent (**Article 8 of the Model CCA Contract**).

To ensure the arm's length outcome of the arrangement on a continuous basis the X group has decided to include two adjustment clauses (**Step 8 of the Step Plan**). The first foresees in prospective adjustments to the methodology for calculating balancing payments in case of relevant changes in business opera-

tions and economic circumstances (**Article 9 of the Model CCA Contract**). The second adjustment clause allows for retrospective adjustments to the valuation of pre-existing contributions under certain specific conditions (**Article 10 of the Model CCA Contract**). The latter clause is based on the OECD model for the use of ex post results in respect of hard to value intangibles.

Furthermore, the X group's CCA contract grants the legal owners the authority to license out cost shared results, provided that the licensing proceeds are shared proportionally among the participants (**Step 9 of the Step Plan / Article 11 of the Model CCA Contract**). Finally it arranges for arm's length buy-in and buy-out payments in case of newly admitted or departing participants and upon termination of the agreement, which would be similar to all but one or all participants departing the agreement (**Step 10 of the Step Plan / Article 12 of the Model CCA contract**).

11.6. Foreign Tax Liabilities

Research objective (v):

To examine the position of CCAs under international tax law and to determine when they may result in a foreign tax liability taking into account their qualification under tax treaties.

The rules and regulations for the governance of CCAs that are currently in force primarily address the transfer pricing aspects of the arrangements. Most of the available literature also focusses on those aspects. The treatment of CCAs under international tax law and their qualification under tax treaties have been given far less attention. To determine such treatment and qualification tax practitioners therefore generally have to rely on the more general provisions of applicable national tax laws and tax treaties. In this context it should firstly be acknowledged that as a commonly accepted principle a participation in a CCA by itself does not cause group companies to have a permanent establishment abroad or a corresponding foreign tax liability. While a CCA foresees in the sharing of costs and risks of certain business activities, it does not change the fact that the resources used in the process remain at the disposal of their legal owner, which applies them in the course of its own business. To avoid uncertainty about the existence of a permanent establishment in practice, I suggested wording in Paragraph 8.2 to be included in the Commentary to Article 5 of the OECD Model Tax Convention to clarify this issue.

Secondly, it should be recognized that a CCA related foreign tax liability can result from the qualification of balancing payments as a category of income, in respect of which the source state has reserved a taxation right under its tax

treaties and effectuates such right under its national tax law. Such qualification can then result in source state withholding tax on the balancing payments. However, that will only occur under specific circumstances. This is described in Paragraph 8.3, which in Paragraph 8.3.6 includes a flowchart summarizing the overall situation. Most notably balancing payments could be subjected to source state withholding taxation, if they are qualified as royalty income. That would be possible, if the payments are related to an intangible in which the payer does not obtain a proportionate part of the effective ownership under the CCA. This could be the case in two instances:

- (i) The pre-existing intangibles are made available for use by the payee without a transfer of their ownership – An example would be the existing manufacturing technology for the production of a first generation product, which is further developed under the CCA into new technology for the production of a second generation product.
- (ii) The new intangibles are developed under a CCA, in respect of which the ownership is not collectively shared among the participants but instead one participant obtains a dominant ownership – An example would be if a software application is developed as part of cost shared information management, which will be accessible to all participants during the course of the CCA, but which is legally owned by one of the participants that is contractually allowed to license and effectively will license out the application without the consent of other participants and without sharing the royalty proceeds with them.

Furthermore, withholding tax could also be payable, if the balancing payments are qualified as services income. That is significantly more likely to occur, if the payment includes a profit element. This can be expected to become more common in the future, as a valuation of contributions at market price was included as a main rule in the Transfer Pricing Guidelines as part of their revision under the OECD's BEPS project. Withholding tax on balancing payments will remain an exception nonetheless, because most countries consider services income to be exclusively taxable in the state of which the recipient is a resident. However, major developing economies have reserved a source state taxation right in their tax treaties and there could therefore be an increase of source state taxation on balancing payments originating from these countries.

Third and finally, it was established in Paragraph 8.4 that the use of immovable property under a CCA should generally not lead to a foreign tax liability of partic-

ipants in the situs country. This does require that the CCA foresees in adequate terms and conditions for the use of the immovable property and the sharing of benefits related to it. Some doubt may still arise, if any capital gain upon sale of the property is shared. In that case tax authorities of the situs state can be expected to seek to tax such income in the hands of the foreign participants. This could quite simply be avoided by compensating the legal owner during the course of the CCA with a businesslike compensation for all its contributions including making the immovable property available, while leaving all indirect income from such property exclusively with that same legal owner.

11.7. Potential Improvement of CFC Rules

Research objective (vi):

To consider how anti-abuse rules aimed at including income of controlled foreign corporations in the taxable base of their domestic parent ("CFC rules") can be improved so that they more effectively counter the use of CCAs in tax avoidance structures.

The examples considered in Paragraph 2.3.2 illustrate how MNEs can fairly easily bypass traditional CFC rules. This is primarily made possible by how those rules have so far calculated the CFC income to be included in the parent's domestic taxable income and the many exceptions allowed in that respect. It goes beyond the scope of this research to discuss in detail the workings and flaws of the various present day CFC regimes, but the historical background and general purpose of CFC rules in general as well as their interaction with CCAs were briefly discussed in Chapter 9. It was also explained there how better drafted CFC legislation might help to prevent base erosion and profit shifting by supplementing transfer pricing rules and neutralizing the reallocation of income generating assets to tax havens, thus countering what I have referred to as transfer pricing manipulation and preemptive ownership reallocation (see Paragraph 9.3.1). Most notably, CFC rules can be expected to become more effective at keeping MNEs from granting affiliates in low tax jurisdiction cheap access to both pre-existing and newly developed intangibles under a CCA, if excess returns from intangibles are included in the CFC income. Where the US was first to introduce CFC rules in the nineteen sixties, by introducing the special regime for so called Global Intangible Low Taxed Income ("*GILTI*") as part of its 2017 Tax Reform Act it is again a frontrunner. As explained in Paragraph 9.3.2, the *GILTI* regime considers any return of CFCs above a routine 10% of its tangible business assets so called intangible income and, as such, qualifies it as taxable in the hands of the US parent. By allowing a fixed 50% deduction

the effective tax rate on GILTI is 10.5% and with an 80% tax credit for foreign income tax that limits additional US taxation to situations in which the income was subject to less than 13.125% taxation abroad. By simultaneously lowering the effective income tax on foreign derived intangible income, the US makes a thorough attempt to remove the incentive for allocating intangible property to low taxed subsidiaries. At the time of writing it is still to be seen how the GILTI regime is further specified in regulations and what avoidance measures taxpayers are able to think up for continued arbitration. However, at first sight the regime appears to present a firm answer to tax haven structures and, if this is sufficiently confirmed in practice, it is likely to be imitated by other tax administrations.

11.8. Potential Improvement of Upfront Certainty and Dispute Resolution Procedures

Research objective (vii):

To propose improvements to procedures for obtaining upfront certainty as well as for dispute resolution aimed at increasing their effectiveness in situations involving a CCA.

There is a long standing tradition among critics of the ALS to argue that its principle based way of determining transfer prices facilitates transfer price manipulation and tax avoidance. The frequently suggested alternative consists of so called formula based apportionment (see Paragraph 3.2.1.). This would be more rule based and therefore leave less room for arbitration. However, a system of formula based apportionment would only be possible without a distorting amount of double taxation, if it would be applied on a global scale in a consistent manner. As different economies will have different interests when it comes to setting the parameters of such a system, it is unlikely that political agreement can be reached about its implementation. Accepting this means that, instead of replacing the ALS, alternative solutions to its flaws should be considered. It is commonly understood that those could come from the further enhancement of procedures for obtaining upfront certainty or resolving disputes in respect of transfer pricing methods and the OECD addressed both in the BEPS Project Final Reports. Unfortunately these reports did not include any proposals aimed specifically at increasing the effectiveness of procedures in respect of cases that involve a CCA. I consider that a missed opportunity, because those cases can lead to specific issues that are difficult, if not impossible to resolve under the current procedures. These issues are primarily caused by the participation of group companies from more than just two countries in the CCA. That implies

that an advance pricing agreement will only have full coverage, if it is multilaterally signed off on by the tax administration of all jurisdictions involved. If more multilateral APAs were concluded, that would not only minimize instances of double taxation, it would also improve transparency, improve transfer pricing insights of both taxpayers and tax authorities, avoid harmful tax competition between jurisdictions and better guarantee an appropriate allocation of the tax base. For these reasons I feel that the OECD should step up efforts to accommodate the conclusion of multilateral APAs. As a start it could use the suggested outline of an APA request involving a CCA as presented in Paragraph 10.2.2 to draft a standard for such request and publish this as an annex to Chapter VIII of the Transfer Pricing Guidelines.

When it comes to dispute resolution procedures their general non-binding and non-mandatory nature pose further obstacles next to their ineffectiveness in multilateral situations. Fortunately, there does appear to be a trend of more jurisdictions agreeing on binding and mandatory mutual agreement procedures, for example in an EU context. In addition it would in my opinion be helpful, if the article on dispute resolution in model tax conventions is extended with a paragraph covering profit adjustments in respect of which corresponding adjustments are needed in more than one jurisdiction in order to avoid economic double taxation. A text proposal for this purpose is included in Paragraph 10.3.3. Under that proposal a contracting state making such a profit adjustment would be required to endeavor to reach a mutual agreement not only with the competent authorities of the other contracting state, but also with the competent authorities of any non-contracting state in which affected affiliated taxpayers are located. That is intended to result in simultaneous or even multilateral procedures. Such backstop would require tax administrations making a profit adjustment to better substantiate and defend the adjustments. As such, it could ensure a more consistent tax and transfer pricing treatment of CCAs and offer better protection against double taxation.

11.9. The Future of CCAs after BEPS and US Tax Reform

This Chapter 11 completes my research on CCAs. These arrangements were introduced in the United States to offer taxpayers a practical instrument for the legal and fiscal structuring of group-wide intangible assets development. They were intended to reduce transfer pricing complexity, but were only partially successful at that. Although CCAs offer participants free access to cost shared assets and services, they defer transfer pricing issues to the valuation of contributions. In addition to that, determining the correct tax treatment of transactions under these arrangements has proven to be potentially cumbersome,

sometimes resulting in new uncertainty and disputes. Furthermore, their ability to allocate the effective ownership of valuable intangibles to foreign group companies in exchange for only a minimal consideration has made CCAs a popular tool for use in tax avoidance structures. The foregoing has caused CCAs to be a subject of frequent and lively fiscal debate.

The findings from this study imply that there is a future for CCAs in a world after BEPS and US tax reform. It has been demonstrated that there are legitimate reasons for MNEs to implement a CCA (Paragraph 2.3.1) and that it would be inconsistent with the ALS to disallow the arrangements only because they are not commonly found between unrelated parties (Paragraph 3.4). An analysis of more opportunistic tax structures featuring a CCA in Paragraph 2.3.2 identified the two fundamental aspects of the traditional tax treatment that have undoubtedly helped to make them a useful tax avoidance tool: the participation of low substance participants and the valuation of contributions at cost. The IRS have tried to counter base erosion and profit shifting with the help of CCAs by trying to impose higher buy-in payments and by requiring stock-based compensation cost to be shared among participants. An analysis of the US case law in which this has resulted showed that the IRS tries to capture in the buy-in payment the value of the ex-ante commitment to provide ongoing activities under the CCA at cost instead of market price. This is not only overly complex, but it also results in a unjustified frontloading of income and it has proven a source of dispute between the Service and taxpayers (also see Paragraph 4.3.6). The OECD on the other hand addressed both aspects with more focus by requiring in the revised Chapter VIII of the Transfer Pricing Guidelines that all participants should control the risks associated with their part of cost shared activities and by requiring that as a main rule all contributions are valued at market price (see Paragraph 5.3.2 and 5.3.3). As clearly stated a number of times in this thesis, I prefer the OECD's approach over that of the US Treasury and IRS.

However, it is not so that with the revised Transfer Pricing Guidelines all CCA related issues are solved and the day to day tax and transfer pricing treatment of these arrangements becomes a straightforward matter from hereon. To the contrary, further complexities concern (i) the valuation of contributions, most notably the valuation at market price of pre-existing intangibles, (ii) the proper documentation of a CCA, (iii) the assessment of how balancing payments are to be qualified under tax treaties and (iv) the procedures to obtain upfront certainty from or to resolve disputes with tax authorities. In this thesis I have suggested improvements of the current fiscal practice in respect of each of these aspects. Firstly, the categorization model presented in Paragraph 2.3.3.2 facilitates an accurate delineation of the commercial and financial relationship

between group companies and, as such, can be a starting point to determining the relative value of contributions made under a CCA, both pre-existing intangibles made available from the outset of the CCA and valuable development activities performed during the course of the arrangement. Secondly, the model CCA contract of Paragraph 11.5.2 is aligned with the most recent US Cost Sharing Regulations and OECD Transfer Pricing Guidelines and can be the basis for meeting documentation requirements while simultaneously ensuring that critical preconditions are met. Thirdly, the flow chart of Paragraph 8.3.6 helps to identify if balancing payments are subject to withholding tax under applicable domestic law and tax treaties. Fourthly, the proposals for standardized advance pricing agreement requests and simultaneous or multilateral mutual agreement procedures included in Paragraph 10.2.2 and 10.3.3 can make the formal processes more efficient in situations involving a CCA. Obviously, the situation could be further improved by supplementing the foregoing with an adequate anti-abuse rule. It just so happens that the new and rather innovative so called GILTI regime introduced in the United States as part of the 2017 tax reform is intended to serve exactly that purpose. The GILTI regime aims for any income from intangibles owned by a US group and defined as any income over and above a fixed 10% return on tangible assets to be taxed at a minimum tax rate of 13.125%. If effective, that would remove any arbitration incentive and should thus significantly relax the discussions between taxpayers and tax authorities. As such, a package of measures emerges consisting of enhanced practical guidance combined with certain adjustments to existing rules and regulations, under which a legitimate use of CCAs can be continued while their application for tax avoidance purposes is effectively pared down. How that may work can be illustrated by reviewing the US case studies analyzed in Paragraph 2.3.2. The first and third example featured Bravo Company and Foxtrot Company respectively (see Paragraphs 2.3.2.2 and 2.3.2.4), which used a CSA to place ownership of intangibles with low taxed Swiss and Bermuda group companies that employed no personnel of their own. It is obvious that those companies did not have the capacity to control the risks associated with the cost shared development activities. As such, they do not meet a critical requirement to be allowed participation and therefore they should in today's world be refused access to the CSA, while the tax authorities could proceed to disregard the arrangement otherwise. The second example concerned Echo Company, which also shifted significant profits to a low taxed group company through a CSA (see Paragraph 2.3.2.3). Contrary to the fact pattern of the Bravo case study, in this instance the benefiting Swiss subsidiary did house employees that (at least potentially) were capable to make an educated decision about taking on, laying off or declining risks associated

with the business opportunity presented by the company's participation in the CSA. Hence, the control-over-risk requirement does not necessarily affect this structure. Alternatively however the profit shifting should now be mitigated by a review of the value of contributions made under the CSA. Most notably the R&D activities performed by Echo's US group company should be valued at market price instead of at cost and that would result in significantly higher balancing payments by the Swiss subsidiary to its US parent returning a substantial part of profits to the US.

My overall conclusion from the foregoing is that there is a future for CCAs in the world after the BEPS project and US tax reform. That is one in which they continue to be an effective and efficient transfer pricing instrument for bona fide taxpayers, allowing them to allocate costs and risks associated with joint activities and the ownership of results from such activities appropriately and transparently among participating group companies. At the same time CCAs will be far less useful as a tax avoidance tool, as more adequately defined terms and conditions force on a businesslike outcome. However, this will require international coherent implementation of the rules and regulations governing CCAs as well as their consistent application by tax practitioners in every day fiscal practice. That requires a better understanding of CCAs and their application by taxpayers to result in a common consensus about the appropriate tax and transfer pricing treatment of these arrangements. I hope that this study is able to make a modest contribution to that process.

Annex – Model CCA Contract

[Information specific to the X Electronics case study included in between brackets]

COST CONTRIBUTION ARRANGEMENT

This Agreement is made this day *[date]*, by and between:

1. **[X US]**, established at ... *[United States]*, and
2. **[X Singapore]**, established at ... *[Singapore]*, and
3. **[X United Kingdom]**, established at ... *[United Kingdom]*, and
4. **[X ...]**, established at,

hereinafter jointly referred to as: Participants or individually referred to as: Participant.

- Whereas the Participants are part of the *[X Group]*, a worldwide group of companies involved in *[the manufacturing and sale of consumer electronics]*;
- Whereas the group has chosen to centralize certain 'Global Activities' (as hereinafter defined);
- Whereas the Global Activities make a valuable contribution to the business operations of the Participants, as described in more detail in the group's transfer pricing master file and local files, and therefore each of the Participants expects to benefit from their performance.
- Whereas all Participants employ sufficiently qualified personnel to take decisions about entering into or terminating this Agreement, the scope and content of Global Activities as well as the budget associated with the performance of Global Activities and regularly make these decisions. They therefore jointly control the risks associated with the Global Activities and regularly exercise such control;
- Whereas Participants intend through this Agreement to formalize the arrangement to coordinate Global Activities and to share in the relevant

costs, risks and the 'Results from Global Activities' (as hereinafter defined) in a manner that is consistent with the arm's length standard;

- Whereas all Participants have a reasonable expectation that each Participant's proportional share of the benefits derived from Global Activities undertaken pursuant to this Agreement will be consistent with the Participant's proportional share of the costs of those activities as computed pursuant to this Agreement;
- Whereas [X UK] wishes to perform the role as administrator, coordinator and facilitator of this Agreement;

[These considerations explicate that the most relevant preconditions for organizing the activities at hand under a CCA are met. Quite relevantly they explicitly confirm that all participants exercise control over the risks associated with the cost shared activities and expect a mutual benefit from their participation in the CCA.]

Now therefore Participants agree as follows:

Article 1: Definitions

1. The term 'Agreement' shall mean this Agreement, as this may be updated from time to time;
2. The term 'Global Activities' shall mean all joint development, production or obtainment of tangible assets, intangible assets or services. These are split into the following [three] different categories:
 - ['Strategic Marketing'],
 - ['Research and Development'],
 - ['Executive Management and Support Services'].

It should be noted that shareholder activities and activities providing no or only an incidental benefit, such as activities that are merely a duplication of activities already performed by or for the Participants, are explicitly excluded from Global Activities.

3. The term 'Results from Global Activities' shall mean any and all tangible and intangible assets, including but not limited to brands, trademarks, technology, process technology and know-how, as well as services which originate from Global Activities undertaken pursuant to this Agreement.
4. The term 'Geographical Territory' for a Participant shall mean its country of residence and those countries where [the X Group] is not represented by a local affiliate and which are appointed to that Participant by [the X Group's executive management] as listed and specified in Appendix I.

5. The term 'Pre-existing Contributions' refers to the tangible or intangible assets of pre-existing value made available for purposes of use or further development under this Agreement as listed and specified in Appendix II.
6. The term 'Current Contributions' refers to the functions associated with Global Activities performed under this Agreement as listed and specified in Appendix III.
7. The term 'Balancing Payments' means payments between Participants made to adjust their share in the overall Pre-existing Contributions and Current Contributions.
8. The term 'Net Sales' for a Participant for a given quarter of the calendar year during the term of this Agreement shall mean an amount equal to the sum of the Participant's actual sales to third parties during the period as reported in accordance with generally accepted accounting principles.
9. The term 'Production Costs' for a Participant for a given quarter of the calendar year during the term of this Agreement shall mean an amount equal to the sum of the Participant's actual direct and indirect costs of production activities during the period as reported in accordance with generally accepted accounting principles.

[This Article 1 provides definitions of terms used throughout the rest of the contract. Among others it defines the cost shared activities ('Global Activities'), the measure to assign benefits (in this example: 'Geographical Territory') and the measure to allocate costs (in this example: 'Net Sales' and 'Production Costs'). The Geographical Territories, the Pre-existing Contributions and the Current Contributions are still to be further specified in Appendix I – III.]

Article 2: Effective and Legal Ownership of Results from Global Activities

1. Each Participant shall be the exclusive effective owner of all Results from Global Activities to the extent they pertain to its operations.
2. Each Participant shall have free access to, and be kept informed of all Results from Global Activities that pertain or could in future pertain to its operations.
3. For purposes of Paragraph 1 and 2 of this Article 2, intangible assets resulting from Strategic Marketing are considered to pertain to a Participant's operations to the extent that they are used in relation to sales to third parties in that Participant's Geographical Territory.
4. For purposes of Paragraph 1 and 2 of this Article 2, intangible assets resulting from Research and Development are considered to pertain to a Participant's operations to the extent they are used in relation to manufacturing at that Participant's production sites.

5. In relation to their use of Results from Global Activities in accordance with this Article 2, Participants will not be charged any amount other than that which is payable by them as Balancing Payments under this Agreement.
6. For convenience of administration and greater protection of intellectual property, legal title to, but not effective ownership of, all and any intellectual property rights related to the Results from Global Activities may be held by [X US, X UK and X Singapore]. The Participants agree to undertake or otherwise participate in all necessary and appropriate steps to vest legal title to, but not effective ownership of, all and any intellectual property rights related to the Results from Global Activities in [X US, X UK and X Singapore].

[This Article 2 assigns the effective and legal ownership of cost shared results. It also clarifies in Paragraph 6 that, while effective ownership is shared among all participants, legal ownership is centralized.]

Article 3: Pre-existing Contributions

1. Participants agree that Participants making Pre-existing Contributions under this Agreement will receive an arm's length compensation equal to the value of those contributions.
2. The valuation of Pre-existing Contributions for purposes of determining the compensation referred to in Paragraph 1 of this Article 3 will observe the guidance provided in the OECD Transfer Pricing Guidelines as in force at the time of such valuation.
3. Appendix II to this Agreement contains a specification of all Pre-existing Contributions, their value and the valuation method applied to determine such value.

[This Article 3 addresses the identification and valuation of Pre-existing Contributions. Appendix II would include a description of all tangible and intangible assets contributed under the CCA, either as a platform asset or as an asset used to perform cost shared activities. It would further indicate per asset or asset class how its value was determined. It should however be considered that this Appendix II will be very case specific. As such, including an example for the X Electronics case study was considered to defy purpose.]

Article 4: Current Contributions

1. Participants agree that Participants making Current Contributions under this Agreement will receive an arm's length compensation equal to the value of those contributions.

2. Valuation of Current Contributions for purposes of determining the compensation referred to in Paragraph 1 of this Article 4 will observe the guidance provided in the OECD Transfer Pricing Guidelines as in force at the time of such valuation.
3. Appendix III to this Agreement contains a specification of all Current Contributions, their value and the valuation method applied to determine such value.

[This Article 4 addresses the identification and valuation of Current Contributions. Appendix III would include a description of the functions performed by each of the participants. It would further indicate per function how it was valued. Just like Appendix II, this will be unique to the CCA at hand and therefore it was decided not to include an example for the X Electronics case study.]

Article 5: Balancing Payments

1. The compensation for Pre-existing Contributions and Current Contributions payable in accordance with Article 6 and 7 of this Agreement will be settled through Balancing Payments.
2. [X UK] will make all calculations (denominated in US dollars) required for establishing all necessary Balancing Payments on a quarterly basis in accordance with the methodology outlined in this Agreement.
3. [X UK] will inform each Participant of the results of its calculations under this Agreement and issue a debit or credit note as appropriate to each Participant before the end of the [10th] working day after quarter-end.
4. All invoices and credit notes are payable within [20] working days of the note date.

[This Article 5 appoints a central administrator to the CCA and arranges practicalities around invoicing and settlement of Balancing Payments.]

Article 6: Strategic Marketing

1. The Participants have determined that each Participant's Net Sales in any quarter of the calendar year during the term of this Agreement reasonably reflect that Participant's anticipated benefits from the Strategic Marketing in that quarter. Therefore, the Participants agree that they will share costs related to Strategic Marketing in proportion to their Net Sales.
2. For the purpose of the calculation of Balancing Payments under Article 5 of this Agreement the aggregated value of Pre-existing Contributions and Current Contributions related to Strategic Marketing made in any quarter of the calendar year is divided by the aggregated amount of Net Sales in

the same quarter and multiplied by the Net Sales of the individual Participants in that quarter.

[This Article 6 prescribes how balancing payments are to be calculated in respect of Strategic Marketing on the basis of Net Sales: If total Net Sales of a Participant in a quarter is 100 and the total Net Sales of all Participants in that quarter is 1,000, then this Participant is allocated 10% of the costs related to Strategic Marketing in that quarter. To the extent that the Participant's own marketing related contributions are valued at a lower or higher lower amount, it will pay or receive a balancing payment under Article 5.]

Article 7: Research and Development

1. The Participants have determined that each Participant's Production Costs in any quarter of the calendar year during the term of this Agreement reasonably reflect that Participant's anticipated benefits from Research and Development in that quarter. Therefore, the Participants agree that they will share costs related to Research and Development in proportion to their Production Costs.
2. For the purpose of the calculation of Balancing Payments in accordance with Article 5 of this Agreement, the aggregated value of Pre-existing Contributions and Current Contributions related to Research and Development made in any quarter of the calendar year is divided by the aggregated amount of Production Costs in the same quarter and multiplied by the Production Costs of the individual Participants in that quarter.

[This Article 7 prescribes how balancing payments in respect of Research and Development are to be calculated on the basis of Production Costs: If total Production Costs of a Participant in a quarter is 100 and the total Production Costs of all Participants in that quarter is 1,000, then this Participant is allocated 10% of the costs related to Research and Development in that quarter. To the extent that the Participant's own R&D related contributions are valued at a lower or higher lower amount, it will pay or receive a balancing payment under Article 5.]

Article 8: Executive Management and Support Services

1. [X US and X UK] will allocate their Current Contributions related to Executive Management and Support Services in any quarter of the calendar year among the Participants based on time spent by their respective personnel in that quarter and the Balancing Payments in respect of Executive Management and Support Services will be calculated accordingly.

2. Upon request [X US and X UK] will present each Participant with a copy of its timekeeping administration to evidence the correctness of the allocations under Paragraph 1 of this Article 8.

[This Article 8 prescribes how balancing payments in respect of Executive Management and Support Services are to be calculated on the basis of time spent.]

Article 9: Adjustments of the Method for the Calculation of Balancing Payments

1. The Participants will review on an annual basis the methodology used for the calculation of Balancing Payments under the Articles 6, 7 and 8 of this Agreement.
2. If found necessary to ensure that the calculation of Balancing Payments remains appropriate in light of the nature of the Global Activities undertaken, the business operations of Participants and the general economic conditions effecting the financial position of [the X Group and its subsidiaries], the Participants will agree in writing on prospective adjustments to the methodology used for the calculation of balancing payments.

[This Article 9 allows for a periodic review of the cost allocation mechanism and a prospective adjustment in case of changes to relevant circumstances.]

Article 10: Adjustments of the Valuation of Pre-existing Contributions

1. The valuation of Pre-existing Contributions will be retroactively adjusted, if their initial valuation considered projected financial results, while considering actual financial results leads to an adjustment of more than 20% of such valuation.
2. No adjustment will be made however, if (a) the difference between the projected financial results and the actual financial results is caused by circumstances that in reasonableness were not foreseeable at the time of the initial valuation or (b) the difference between projected financial results and the actual financial results during the first five years after the initial valuation were not so material that they led to an adjustment under Paragraph 1 of this Article 10.
3. Any adjustments to the valuation of Pre-existing Contributions under this Article 10 will be reflected in the calculation of Balancing Payments under Article 5 of this Agreement in the current quarter.

[This Article 10 allows for a review of the valuation of Pre-existing Contributions and a retrospective in case ex post financial results deviate materially from forecasted results. The adjustment clause, including the deviation percentage included

in Paragraph 1, is consistent with the OECD's guidance on the treatment of hard to value intangibles, as provided in Paragraph 6.193 of the Transfer Pricing Guidelines.]

Article 11: Authorizations to X US, X UK and X Singapore

1. As effective owners of all intangible assets created or enhanced under this Agreement, the Participants hereby grant to [X US, X UK and X Singapore or its designee(s)] the authority to license out the Results of Global Activities to third parties on their behalf.
2. The proceeds of the licensing out of the Results of Global Activities under Paragraph 1 of this Article 11 are allocated to Participants in proportion to their share in effective ownership of the Results of Global Activities and are reflected in the calculation of Balancing Payments under Article 5 of this Agreement.
3. For purposes of the allocation of proceeds under Paragraph 2 of this Article 11, the aggregated amount of proceeds from licensing out marketing intangibles received in any quarter of the calendar year is divided by the aggregated amount of Net Sales in the same quarter and multiplied by the Net Sales of the individual Participants in that quarter.
4. For purposes of the allocation of proceeds under Paragraph 2 of this Article 11, the aggregated amount of proceeds from licensing out technology and know-how received in any quarter of the calendar year is divided by the aggregated amount of Production Costs in the same quarter and multiplied by the Production Costs of the individual Participants in that quarter.

[This Article 11 authorizes the licensing out of the Results from Global Activities under the precondition that proceeds are shared proportionally among participants: If total Net Sales of a Participant in a quarter is 100 and the total Net Sales of all Participants in that quarter is 1,000, then this Participant is allocated 10% of the income from licensing out marketing intangibles in that quarter and its balancing payment is positively adjusted accordingly. If total Production Cost of a Participant in a quarter is 100 and the total Production Cost of all Participants in that quarter is 1,000, then this Participant is allocated 10% of the income from licensing out technology and know-how in that quarter and its balancing payment is also positively adjusted.]

Article 12: Newly Admitted and Departing Participants

1. If a new Participant is admitted as a Participant under this Agreement (hereinafter referred to as: "New Participant"), the existing Participants or

the New Participant, as the case may be, will make additional Balancing Payments to the other in an amount equal to the difference, if any, between the value of any Pre-existing Contributions made by the New Participant and the value of the tangible and intangible assets made available by the existing Participants to the New Participant upon its admittance.

2. Any New Participant will agree to undertake or otherwise participate in all necessary and appropriate steps to vest legal title, but not effective ownership, in [X US, X UK, X Singapore and/or its designee(s)] of all and any intellectual property rights included in the intangible assets made available to the existing Participants under Paragraph 1 of this Article 12.
3. If a Participant (hereinafter referred to as: “Departing Participant”) terminates its participation in this Agreement and relinquishes its beneficial interests in tangible and intangible assets, the remaining Participants will make additional Balancing Payments to the Departing Participant in an amount that accounts for the value to the remaining Participants of any tangible or intangible assets acquired from the Departing Participant upon its departure.
4. The valuation of tangible and intangible assets for purposes of determining the compensation referred to in Paragraph 1 and 3 of this Article 12 will observe the guidance provided in the OECD Transfer Pricing Guidelines as in force at the time of such valuation.

[This Article 12 sets out the conditions under which new participants can be admitted under the CCA or existing participants can depart. Most relevantly it arranges for buy-in and buy-out payments, in case either event causes the effective transfer of assets between the participants.]

Article 13: Withholding Tax, Indirect Tax and Other Levies

1. All Balancing Payments under this Agreement will be made free and clear of, and without reduction for or on account of, any present or future income, stamp or other taxes, levies, imposts, duties, charges, fees, deductions or withholdings, now or hereafter imposed, levied, collected, withheld or assessed by any governmental authority or any political subdivision or taxing authority thereof or therein (such taxes herein referred to as: Foreign Taxes).
2. If any Foreign Taxes are required to be withheld from any Balancing Payments under this Agreement for which the recipient nor any other member of [the X Group] is able to take a tax credit, the amount of the Balancing Payment shall be increased to the extent necessary to yield to

the recipient the amounts payable under this Agreement after payment of all those Foreign Taxes.

[This Article 13 arranges how withholding tax on balancing payments, if any, is to be handled. To the extent that such withholding tax is not creditable to the recipient of the balancing payment, it is considered at arm's length for the participant making the balancing payment to bear such tax cost.]

Article 14: Representation and Warranty

1. Participants make no express or implied representations, warranties or guarantees relating to the Results from Global Activities.
2. Participants shall use reasonable efforts to perform Global Activities in a professional and workmanlike manner consistent with industry standards.
3. No Participant shall be liable to any other Participant for the consequences of any failure or delay in performing any of its obligations under this Agreement, other than for damages arising from such Participant's gross negligence or willful misconduct.
4. In no event shall a Participant be liable to any other Participant hereto for special, exemplary, incidental, direct, indirect or consequential damages (including, without limitation, lost revenues profits, savings or business) or loss of records or data, whether or not the possibility of such damages has been disclosed to it or could have been reasonably foreseen by it and whether in an action based on contract, warranty, strict liability, tort (including, without limitation, negligence) or otherwise. Any Participant's maximum liability for any claim, loss or other liability arising out of or connected with this agreement, shall in no case exceed the aggregate amounts paid to such Participant under this agreement during the preceding six months. Each Participant's entire liability and the other Participants' remedies under this Agreement shall be subject to the limitations contained in this Paragraph.

[This Article 14 provides for representations and warranties between participants. They can be modified as considered appropriate in light of facts and circumstances of a specific case.]

Article 15: Term and Termination

1. This Agreement shall be deemed to be effective as of *[date]* and shall remain in full force and effect until its termination in accordance with this Article 15.

2. Participants can terminate their participation in this Agreement at their own discretion by issuing a written request to [X UK] observing at least six months prior notice.
2. This Agreement shall be terminated automatically and with immediate effect with respect to a Participant in the event of that Participant's liquidation, bankruptcy or state of insolvency.
3. [X UK] shall have the right to terminate this Agreement with respect to a Participant with immediate effect in the event of any change of more the [25%] in the Participant's shareholders or management.
4. [X UK] shall have the right to terminate this Agreement with respect to a Participant if such Participant does not remedy a material default within ninety (90) days of having received a written notice from [X UK].

[This Article 15 outlines how the CCA can be terminated. This example assumes an open ended agreement. However, parties could also agree a fixed term.]

Article 16: Miscellaneous Provisions

1. To the extent that any of the provisions contained in this Agreement shall be determined to be invalid or unenforceable, no such invalidity or unenforceability shall affect the validity or enforceability of the remaining provisions contained herein. The invalid or unenforceable provision shall be construed as an undertaking of the Participants to make all efforts to procure and effect any amendment or alteration as may be necessary to carry out the intention of the provision in question.
2. The failure of any intended Participant or Participants to execute this Agreement, or the cancellation, termination or invalidity (in whole or in part) of this Agreement with respect to any Participant or Participants, shall not affect the validity or continuation of this Agreement with respect to any Participant or Participants.
3. Modification, amendment or waiver of this Agreement or provision hereof shall only be binding upon any Participant, if made in writing or confirmed in writing by their duly authorized representatives.
4. The Participants agree to make any amendments to this Agreement as may be necessary to ensure compliance with any applicable existing or future tax laws as well as fiscal rules and regulations. Whenever possible, the Participants agree to construe the terms of this Agreement to comply with any applicable legal requirements.
6. In case of termination of this Agreement, the Participants will fulfill all of their obligations due before the termination.

- 7. The rights and obligations of the Participants under this Agreement are entirely personal and this Agreement shall not be assigned without the prior written consent of all Participants.
- 8. Nothing in this Agreement shall be construed to create a partnership among the Participants or to cause any activities undertaken pursuant to this Agreement to constitute a place of business or permanent establishment in the meaning of Article 7 of the OECD Model Tax Convention.
- 9. This Agreement contains no stipulations or provisions for the benefit of a third party or which could be invoked by a third party against a Participant to this Agreement.
- 10. This Agreement may be executed by the Participants in separate counterparts each of which, when so executed and delivered, shall be deemed to constitute an original but all of which together shall constitute one and the same agreement.
- 11. This agreement will be governed by the law of the *[country]* and is subject to adjudication by *[name of appropriate Court]* in case of any arguments or disagreements.

[This Article 16 provides for some further general arrangements, which also can be tailored to accommodate the specific wishes of participants within the margins of what would be acceptable between third parties.]

Agreed and accepted with effect from *[date]*.

By and on behalf of:

[X US]

[X UK]

[X Singapore]

[X ...]

- Appendix I: Specification of Geographical Territories per Participant
- Appendix II: Specification of Pre-existing Contributions
- Appendix III: Specification of Current Contributions

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Nederlandstalige Samenvatting

Introductie

Voor zover mij bekend bestaat er geen Nederlandse vertaling voor het Engelse woord *cost contribution arrangement*. Dit soort overeenkomsten, die meestal wordt gesloten door vennootschappen die onderdeel van de dezelfde multinationale onderneming uitmaken, wordt hierna aangeduid met de afkorting "CCA". Een CCA heeft tot doel bepaalde activiteiten uit te voeren voor gezamenlijke rekening en risico van de deelnemende groepsmaatschappijen. Die activiteiten kunnen bestaan uit het verrichten van conerndiensten en het ontwikkelen van nieuwe bedrijfsmiddelen (materiële of immateriële activa). De deelnemers worden gezamenlijk economisch eigenaar van de resultaten, terwijl om niet-fiscale redenen vaak één groepsmaatschappij als juridisch eigenaar wordt aangewezen. De kosten van de gezamenlijke activiteiten worden verhoudingsgewijs verdeeld al naargelang de deelnemers een voordeel uit hun individuele exploitatie van de resultaten verwachten. Daarmee onderscheidt een CCA zich van de meest gangbare samenwerkingsverbanden tussen onafhankelijke derden, die doorgaans voorzien in een gezamenlijke exploitatie van de resultaten, waarbij deelnemers dan tot de winst zijn gerechtigd al naargelang zij in de kosten hebben gedeeld. Een CCA werkt dus precies andersom en regelt tegelijk hoe de eigendom van de eventueel ontwikkelde bedrijfsmiddelen tussen de deelnemers wordt verdeeld. Dit laatste is uiteraard van groot belang, als aan die bedrijfsmiddelen een groot deel van de toekomstige bedrijfswinsten kan worden toegerekend, zoals het geval kan zijn wanneer het waardevolle immateriële activa betreft.

Onderzoeksdoelstellingen

Er zijn naar mijn mening twee ontwikkelingen te onderkennen, die een verder academisch onderzoek naar de fiscale behandeling van de CCA rechtvaardigen. De eerste bestaat uit het steeds verder toenemende belang van immateriële activa, vooral voor multinationale ondernemingen. De tweede betreft de zorg om belastingontwijking door diezelfde multinationals, onder anderen door

mobiele bronnen van inkomen zoals kapitaal, risico en immateriële activa naar laag belastende jurisdicties te verplaatsen. De cumulatie van deze twee ontwikkelingen heeft ertoe geleid dat de Organisatie voor Economische Samenwerking en Ontwikkeling ("OESO") het versterken van de regels voor het vaststellen van verrekenprijzen, juist ook met betrekking tot transacties waar immateriële activa bij zijn betrokken, tot een speerpunt heeft gemaakt van haar recente project gericht op het tegengaan van grondslaguitholling en winstverschuiving. Ook het herschrijven van het hoofdstuk over CCA's in de OESO-Verrekenprijzenrichtlijnen maakte hier onderdeel van uit. In dat kader en met het uitgangspunt dat het misbruik van CCA's voor doeleinden van belastingontwijking dient te worden bestreden, maar dan wel zonder daarbij het bona fide gebruik van deze overeenkomsten in te perken, heb ik de volgende onderzoeksdoelstellingen geformuleerd:

- (i) de historische achtergrond en de initiële bedoeling van CCA's te onderzoeken en de ontwikkeling vast te stellen van het conceptuele denken over deze overeenkomsten als een legitiem instrument voor het structureren van intra-groep transacties en als een middel om belasting te ontwijken;
- (ii) de legitieme redenen voor het gebruik van een CCA te identificeren, de rol van dit soort overeenkomst in op belastingontwijking gerichte structuren te bepalen en een model voor te stellen om een analyse van het gebruik van een CCA in de praktijk te faciliteren;
- (iii) de belangrijkste wet- en regelgeving, in het bijzonder de Amerikaanse regelgeving en de OESO-Verrekenprijzenrichtlijnen, als ook jurisprudentie betrekking hebbend op CCA's te analyseren en te vergelijken;
- (iv) een stappenplan en een model contract voor de implementatie van een fiscaal acceptabele CCA te ontwikkelen;
- (v) de positie van CCA's onder internationaal belastingrecht en hun kwalificatie onder belastingverdragen te onderzoeken en vast te stellen wanneer deze tot een buitenlandse belastingplicht van deelnemers kan leiden;
- (vi) verbeteringen te beschouwen, die zogenoemd CFC-wetgeving beter in staat stellen om belastingontwijking met gebruik van CCA's tegen te gaan; en

- (vii) voorstellen te doen tot verbetering van procedures voor het verkrijgen van zekerheid vooraf en het wegnemen van dubbele belastingheffing, die ertoe leiden dat deze procedures effectiever worden in situaties waarin een CCA is betrokken.

Historische Achtergrond van het CCA Concept (1^{ste} Onderzoeksdoelstelling)

De eerste officiële regelgeving waarin CCA's expliciet worden geadresseerd is de Amerikaanse verrekenprijzenregelgeving uit de jaren zestig van de vorige eeuw. Het daar geïntroduceerde begrip "*bona fide cost sharing arrangement*" of "CSA" ziet nog uitsluitend op overeenkomsten gericht op het ontwikkelen van immateriële activa. In de toelichtende publicaties is duidelijk aangegeven hoe de gezamenlijke ontwikkeling onder deze overeenkomsten het overdragen of het in licentie geven van de immateriële activa tussen verbonden partijen tot een minimum zou moeten beperken en daardoor lastige waarderingsproblematiek zou moeten voorkomen. In 1979 neemt de OESO het concept onder de naam CCA over in een voorloper van de huidige Verrekenprijzenrichtlijnen. Daarbij stelt zij nog expliciet vast dat dergelijke overeenkomsten in de Amerikaanse ervaring niet buitensporig vaak voor doeleinden van belastingontwijking worden gebruikt. In de jaren daarna verandert deze opvatting echter. In de Verenigde Staten wordt in 1995 specifiek op CSA's gerichte regelgeving gepubliceerd, die in 2002 integraal wordt herzien vanwege een vermoeden dat de overeenkomsten worden gebruikt om immateriële activa tegen onzakelijke voorwaarden naar het buitenland weg te sluizen. In 2011 resulteert dit in nieuwe Amerikaanse regelgeving. De bezorgdheid over belastingontwijking door multinationals in het algemeen en misbruik van CCA's in het bijzonder leeft echter veel breder. Dit is aanleiding voor de G20 om in 2012 de OESO te vragen een internationaal offensief tegen grondslaguitholling en winstverschuiving te coördineren. De OESO stelt vervolgens een Actieplan op, waarbij het versterken van de Verrekenprijzenrichtlijnen, inclusief een herziening van het daarin opgenomen hoofdstuk over CCA's, een prominente plaats inneemt. Het nieuwe Hoofdstuk 8 van de Verrekenprijzenrichtlijnen wordt uiteindelijk op 5 oktober 2015 gepubliceerd.

Legitiem Gebruik en Belastingontwijking (2e Onderzoeksdoelstelling)

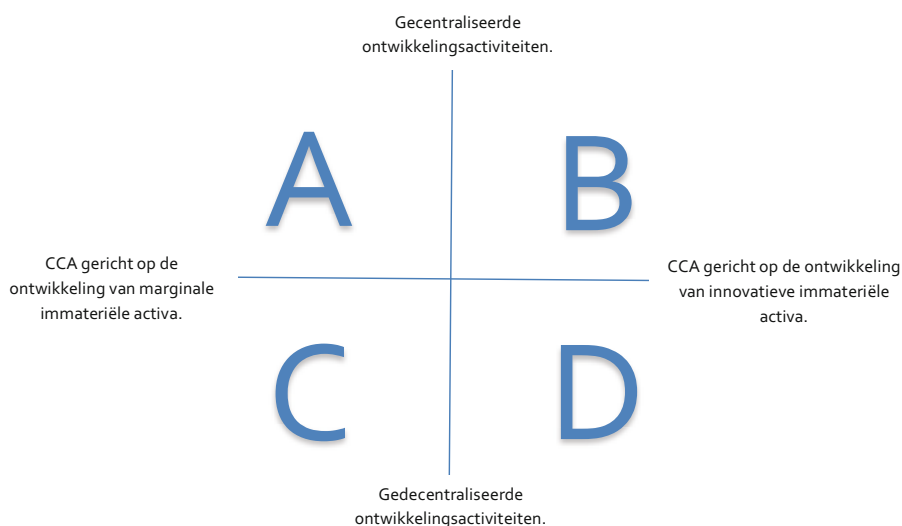
CCA's bieden multinationals de mogelijkheid om kennis en ervaring op effectieve wijze beschikbaar te stellen aan de verschillende groepsmaatschappijen. Ze stellen de groep ook in staat de met onderzoek en ontwikkeling gepaard gaande risico's te delen en zo grootschaliger projecten te ondernemen. Dit kan

in een enkele paraplueveneenkomst worden geregeld, zodat het niet nodig is een complex web van individuele overeenkomsten tussen verschillende groepsmaatschappijen te sluiten. Tegelijkertijd voorkomt het uitgangspunt dat deelnemende groepsmaatschappijen vanaf het ontstaan van nieuw ontwikkelde activa gezamenlijk effectief eigenaar worden, dat deze activa nog moeten worden overgedragen of in licentie worden gegeven, zodat het onnodig naar voren halen van fiscale winst wordt voorkomen en complexe waarderingsvraagstukken worden vermeden. Tot slot kunnen CCA's duidelijkheid verschaffen over de kostenverdeling en bieden zij de mogelijkheid de fiscale acceptatie hiervan op een efficiënte wijze door belastingautoriteiten te laten toetsen.

Tegenover deze legitieme voordelen van CCA's staat dat de overeenkomsten ook zijn ingezet voor het verschuiven van belastbare winst van hoger naar lager belastende jurisdicties. Daarbij wordt met name gebruik gemaakt van twee controversiële elementen in de fiscale behandeling van CCA's. Het eerste hier bedoelde element betreft de lange tijd geaccepteerde deelname aan een CCA van entiteiten met weinig reële economische capaciteit ("*substance*"). Het tweede element bestaat eruit dat CCA's traditioneel voorzagen in een compensatie van onder deze overeenkomsten verrichte activiteiten tegen kostprijs. Samen maakten beide elementen het mogelijk dat een kasgeldvennootschap met minimale werknemers of activiteiten, gevestigd in een laag belastend land, door deelname in een CCA tegen een beperkte vergoeding mede-eigenaar kon worden van feitelijk in een hoog belastend land ontwikkelde nieuwe immateriële activa. Als deze vervolgens bijvoorbeeld aan andere groepsmaatschappijen in licentie werden gegeven, was het effectieve resultaat dat door royaltybetalingen een aanzienlijk deel van de groepswinst naar een fiscaalvriendelijker omgeving kon worden geleid.

In Paragraaf 2.3.3.2 van mijn proefschrift wordt een categorisatiemodel voorgesteld dat fiscalisten kan helpen een bepaalde situatie te analyseren en vast te stellen of een CCA een legitiem instrument is om tot passende verrekenprijzen voor interne transacties te komen of juist een verhoogd risico op een onzekelijke uitkomst met zich brengt. Dit model gaat ervan uit dat bij het gebruik van een CCA voor de ontwikkeling van immateriële activa twee aspecten van bijzonder belang zijn: De rol van de betreffende activa in de waardeketen van de multinational en de wijze waarop die multinational zijn organisatiestructuur heeft ingericht. Wat betreft de rol van de immateriële activa in de waardeketen kan een onderscheid worden gemaakt tussen twee verschillende typen immateriële activa. Het eerste type betreft waardevolle, innovatieve immateriële activa, die een geheel nieuw product of productieproces mogelijk maken of een bestaand product of productieproces ingrijpend verbeteren. Het tweede

type betreft minder waardevolle, meer marginale immateriële activa, die een bestaand product of productieproces slechts beperkt verbeteren. De innovatieve immateriële activa komt men stereotypisch tegen in hightech sectoren, zoals de farmaceutische en software industrie, de marginale immateriële activa vindt men in meer traditionele sectoren, zoals de bulkchemie. Het tweede als onderdeel van het categorisatiemodel te beschouwen aspect, de organisatiestructuur van de belastingplichtige, maakt een onderscheid tussen centraal uitgeoefende en decentraal uitgeoefende ontwikkelingsactiviteiten. Bij een gecentraliseerde organisatie worden de activiteiten door een beperkt aantal groepsmaatschappijen uitgevoerd en bij een gedecentraliseerde organisatie juist door meerdere. Vanwege de ongelijke bijdragen van verschillende deelnemers lijkt het minder voor de hand te liggen om gecentraliseerde ontwikkelingsactiviteiten door middel van een CCA te structureren dan gedecentraliseerde ontwikkelingsactiviteiten. Als de beide aspecten op verschillende assen tegen elkaar worden afgezet, resulteert dat in het volgende model:



Bij CCA's uit het noordoostelijke kwartiel 'B' is sprake van een verhoogd risico op een onzakelijke uitkomst en dus op oneigenlijk gebruik. Bij CCA's uit het zuidwestelijke kwartiel 'C' is de kans hierop aanzienlijk minder groot.

Amerikaanse CSA Regelgeving vs. OESO Verrekenprijzenrichtlijnen (3^{de} Onderzoeksdoelstelling)

Als het gaat om het tegengaan van grondslaguitholling en winstverschuiving kiezen de Amerikaanse belastingautoriteiten en de OESO een fundamenteel andere benadering. De Amerikaanse regelgeving stelt traditioneel geen eisen aan de reële economische capaciteit van deelnemers. Bovendien kunnen onder een Amerikaanse CSA verrichte werkzaamheden met een kostenvergoeding, dat wil zeggen zonder winstelement, worden gecompenseerd. Daarentegen gaat de Amerikaanse regelgeving ervan uit dat deelnemers een hoge inkoopvergoeding toekomt, indien zij zich bij het aangaan van de CSA committeren bepaalde activiteiten voor niet meer dan een kostenvergoeding te verrichten. Tot nu toe heeft deze benadering de rechterlijke toets echter niet succesvol kunnen doorstaan. In de zaken *“Veritas”* en *“Amazon”* oordeelde de rechter dat de wijze waarop de Amerikaanse IRS de inkoopvergoeding berekende niet in overeenstemming was met de geldende regels en de zakelijkheidsstandaard. Beide zaken zijn nog gewezen onder oude, inmiddels vervangen regelgeving. De technische onderbouwing van de uitspraken geven echter geen aanleiding voor hoop op een andere uitkomst onder de recentere, aangepaste regelgeving. Ten eerste wezen de rechters tot nu toe de veronderstelling van de hand dat *“zachte”* elementen, zoals de aanwezigheid van deskundig en ervaren personeel of de ondernemingskans geboden door de mogelijkheid om deel te nemen aan de CSA, als een immaterieel activum kunnen worden aangemerkt dat zelfstandig tegen een vergoeding kan worden overgedragen. Ten tweede gingen zij niet mee in de waardering op geaggregeerde basis van deze mengelmoe van veronderstelde immateriële activa. Dat is niet onlogisch, aangezien het onderling verband tussen deze activa beperkt is en zij doorgaans een zeer van elkaar verschillende levensduur hebben. Tot slot kan worden opgemerkt dat het vereiste om een inkoopvergoeding vast te stellen indruist tegen de bedoeling van het Amerikaans Congres bij de herbevestiging van de CSA als een legitiem instrument voor het structureren van groepstransacties, namelijk om complexe waarderingsvraagstukken te vermijden.

In het licht van het voorgaande lijkt de alternatieve aanpak van de OESO niet alleen systematisch zuiverder, maar ook doelmatiger. Deze bestaat uit twee fundamentele wijzigingen in Hoofdstuk 8 van de Verrekenprijzenrichtlijnen over CCA's. Ten eerste wordt onder de aangepaste Verrekenprijzenrichtlijnen als voorwaarde gesteld dat elke deelnemer aan een CCA de risico's ten aanzien van zijn deelname dient te controleren. Wanneer een groepsmaatschappij daarentegen de reële economische capaciteit ontbeert om een dergelijke controle uit te oefenen, dan kan deze groepsmaatschappij per definitie niet deelnemen en zijn

belastingautoriteiten zo nodig bevoegd de transacties onder de CCA fiscaal te herkwalficeren. Ten tweede vereisen de herziene Verrekenprijzenrichtlijnen dat op enkele uitzonderingen na alle bijdragen onder een CCA op marktconforme basis, dat wil zeggen in de regel met inbegrip van een winstelement, worden gewaardeerd. Dit betekent dat in het bijzonder voor waardevolle ontwikkelingsactiviteiten een hogere compensatie zal moeten worden betaald, terwijl enkel het verstrekken van passieve financiering niet meer kan opleveren dan een risico-gecorrigeerde rente. Ook dit vraagt een zekere waarderingsinspanning. Echter, deze wordt veel overzichtelijker en minder complex door de individuele bijdragen elk voor zich te beschouwen en de eerder vermelde “zachte” immateriële activa, zoals ervaren en deskundig personeel of een unieke ondernemingskans, in aanmerking te nemen als datgene wat ze daadwerkelijk zijn: Een vergelijkingsfactor die mee dient te worden gewogen bij het bepalen van de waarde van onder de CCA verrichte activiteiten.

Een Zakelijke CCA (4^e Onderzoeksdoelstelling)

Met in acht name van het voorgestelde categorisatiemodel en de herziene OESO regels kan het volgende stappenplan worden opgesteld voor het opzetten van een zakelijke, fiscaal acceptabele CCA:

1. De onder de CCA te verrichten werkzaamheden dienen te worden geïdentificeerd. Aandeelhoudersactiviteiten en duplicatie van diensten dienen hiervan te worden uitgesloten en ook dienen geen werkzaamheden te worden inbegrepen die geen of slechts een incidenteel voordeel voor andere groepsmaatschappijen opleveren.
2. Het dient te worden zeker gesteld dat alle deelnemende groepsmaatschappijen met hun deelname aan de CCA een voordeel verwachten te behalen dat uit meer bestaat dan een geldelijke vergoeding voor het verrichten van werkzaamheden.
3. Het dient te worden zeker gesteld dat alle deelnemende groepsmaatschappijen de aan de CCA gerelateerde risico's gezamenlijk controleren. Dat wil zeggen dat elke deelnemer voldoende deskundig personeel in dienst dient te hebben, dat afgewogen beslissingen neemt over het toetreden tot de CCA, het beëindigen van de deelname in de CCA, het doel en de strekking van de onder de CCA te verrichten werkzaamheden en het daarvoor benodigde budget.

4. De economische en juridische eigendom van verwachte resultaten dient helder en eenduidig te worden verdeeld onder individuele deelnemers, bij voorkeur op een exclusieve wijze en zonder overlap.
5. Bijdragen in natura anders dan het verrichten van werkzaamheden, in het bijzonder ter beschikking gestelde immateriële platform activa, dienen te worden geïdentificeerd en op passende wijze te worden gewaardeerd.
6. Onder de CCA verrichte werkzaamheden dienen te worden geïdentificeerd en op passende wijze te worden gewaardeerd.
7. Een berekeningswijze voor compensatiebetalingen dient te worden overeengekomen. Deze dient erin te resulteren dat de totale bijdragen van alle deelnemers proportioneel zijn ten opzichte van hun verwachte voordeel uit hoofde van de CCA. Deze berekeningswijze dient prospectief te kunnen worden aangepast, indien de omvang van de te verrichten werkzaamheden of de aard van de ondernemingsactiviteiten van deelnemers verandert dan wel de economische, commerciële of financiële omstandigheden waaronder zij opereren veranderen.
8. Optioneel kan een prijsaanpassingsclausule worden opgenomen ten aanzien van de hierboven onder punt 5 vermelde bijdragen. Een dergelijke clausule zou erin kunnen voorzien dat de waardering van deze bijdragen met terugwerkende kracht wordt aangepast, indien de resultaten uit de exploitatie van onder de CCA ontwikkelde nieuwe immateriële activa sterk afwijken van de oorspronkelijke verwachtingen.
9. Indien het de bedoeling is dat onder de CCA ontwikkelde immateriële activa in licentie worden gegeven aan verbonden of niet-gelieerde niet-deelnemers worden gegeven, dient de juridische eigenaar hiertoe te worden gerechtigd onder de voorwaarde dat de opbrengst met andere deelnemers wordt gedeeld naar evenredigheid van de door hen uit de CCA verwachte voordelen.
10. Tenslotte dient de toe- en uittreding van deelnemers als ook de beëindiging van de CCA te worden geadresseerd. In het bijzonder dient te worden bepaald dat tussen deelnemers een zakelijke vergoeding zal worden betaald, indien een dergelijke gebeurtenis tot een overdracht van bedrijfsmiddelen leidt.

In Paragraaf 11.5 is dit stappenplan toegepast op een gestileerde casus, waarvoor aldaar tevens een model contract is uitgewerkt.

Buitenlandse Belastingplicht als gevolg van Deelname aan een CCA (5^e Onderzoeksdoelstelling)

Er bestaat weinig specifieke regelgeving ten aanzien van de positie van CCA's onder internationaal belastingrecht of de kwalificatie van deze overeenkomsten onder bilaterale belastingverdragen. De fiscale praktijk is daarom meestal aangewezen op meer algemene bepalingen in nationale wetgeving en verdragen. In dit kader kan ten eerste worden opgemerkt dat op zichzelf deelname in een CCA geen aanleiding zou moeten zijn om een vaste inrichting en een bijbehorende buitenlandse belastingplicht vast te stellen. Hoewel onder een CCA kosten en risico's van bepaalde bedrijfsactiviteiten worden gedeeld, blijven de in dat kader gebruikte bedrijfsmiddelen ter beschikking van hun juridische eigenaar, die ze aanwendt in het kader van de eigen bedrijfsuitoefening. Ten einde elke nog bestaande onduidelijkheid hierover weg te nemen, is in Paragraaf 8.2 een voorstel gedaan voor een aan het commentaar bij Artikel 5 van het OESO-Modelverdrag toe te voegen tekst.

Verder dient te worden onderkend dat compensatiebetalingen kunnen zijn onderworpen aan bronstaatheffing. Dit doet zich voor als onder het nationale recht van de bronstaat of een toepasselijk belastingverdrag een dergelijke belasting is verschuldigd, bijvoorbeeld indien de compensatiebetaling als een royalty wordt aangemerkt. Dat zou het geval zijn, wanneer de betaling is gerelateerd aan het gebruik van een immaterieel activum en de betalende groepsmaatschappij in ruil voor de betaling geen proportioneel aandeel in de effectieve eigendom van dat immateriële activum verkrijgt. Daarvan is sprake indien (i) het een vooraf bestaand, dus niet nieuw ontwikkeld activum betreft, dat onder de CCA ter beschikking wordt gesteld zonder dat de eigendom ervan wordt overgedragen of (ii) het een nieuw ontwikkeld activum betreft, waarvan de eigendom niet proportioneel wordt gedeeld, dat wil zeggen waarin ten minste één andere participant een meer absoluut eigendomsrecht verkrijgt (bijvoorbeeld wanneer deze overbedeelde participant het immateriële activum op eigen gelegenheid aan derden in licentie kan geven of vervreemden, zonder de opbrengst met andere CCA deelnemers te hoeven delen). Verder kunnen compensatiebetalingen ook aan bronbelasting zijn onderworpen, indien zij als inkomen uit dienstverlening worden gekwalificeerd. Het ligt meer voor de hand dat dit zal gebeuren, indien de betaling niet alleen uit een kostenvergoeding bestaat maar ook een winstelement bevat. Dat laatste zal in de toekomst vaker het geval zijn, nu de herziene OESO-Verrekenprijzenrichtlijnen een waardering

van alle bijdragen op marktconforme basis voorschrijven. Dat neemt niet weg dat het een uitzonderingssituatie zal blijven, omdat de meeste landen inkomen uit dienstverlening aan het woon- in plaats van het bronland toewijzen. Dat geldt echter niet voor majeure, opkomende economieën, zoals India en Brazilië, die zich in hun bilaterale belastingverdragen doorgaans wel degelijk een heffingsrecht hebben voorbehouden voor een dergelijk inkomen. Een stroomschema, dat de verschillende hier beschreven situaties van bronstaatheffing samenvat, is opgenomen in Paragraaf 8.3.

Potentiële Verbeteringen van CFC-Regels (6^e Onderzoeksdoelstelling)

De huidige CFC-regelgeving is niet erg succesvol gebleken in het tegengaan van het gebruik van CCA's om waardevolle immateriële activa aan dochtermaatschappijen in laag of lager belastende jurisdicties te verplaatsen. Het is aannemelijk dat deze regelgeving effectiever zou zijn, indien zij het bovenmatig inkomen uit dergelijke immateriële activa in het belastbare inkomen van de moedermaatschappij zouden betrekken. Met de belastingherziening van 2017 nemen de Verenigde Staten, die vaak zijn bekritiseerd om hun gebrekkige CFC-regelgeving en zogenoemde "*check-the-box*"-regime, hierin het voortouw. Het nieuwe regime is er op gericht al het inkomen van buitenlandse dochtermaatschappijen, voor zover dit een forfaitair resultaat van 10% op hun materiële activa overtreft, bij de Amerikaanse moeder te belasten tegen een effectief tarief van 10,5%. Daarbij kan de moedermaatschappij tot 80% van de eventuele buitenlandse belasting op dit inkomen verrekenen. Dit zorgt ervoor dat dubbele belastingheffing grotendeels wordt voorkomen en dat per saldo slechts een Amerikaanse bijheffing plaatsvindt, indien het buitenlandse belastingtarief lager is dan 13,125%. Door gelijktijdig een vergelijkbaar laag effectief tarief op met immateriële activa uit buitenlandse bron genoten inkomen in te voeren, zou het vanuit een Amerikaanse perspectief minder relevant moeten worden waar immateriële activa worden gehouden. Ten tijde van de afsluiting van dit manuscript is nog geen regelgeving gepubliceerd, waarin het nieuwe regime verder wordt uitgewerkt. Ook zal nog moeten blijken in welke mate de belastingadviespraktijk in staat blijkt ontgaan- en arbitragemogelijkheden te bedenken. Als de nieuwe regels echter effectief blijken, dan zou het de populariteit van CSA's en CCA's in agressieve structuren aanzienlijk kunnen verminderen. In dat geval is het niet onaannemelijk dat het nieuwe Amerikaanse regime ook in andere landen in min of meer vergelijkbare vorm zal worden overgenomen.

Potentiële Verbetering van Procedures voor het Verkrijgen van Zekerheid Vooraf en Regelingen van Onderling Overleg (7^e Onderzoeksdoelstelling)

Criticasters van de zogenoemde “*arm’s length standaard*”, de internationale standaard waaronder transacties tussen verbonden partijen tegen marktconforme prijzen dienen te worden geprijsd, brengen vaker naar voren dat deze standaard te veel op principes en te weinig op regels is gebaseerd. Daardoor zou hij vatbaar zijn voor manipulatie en belastingontwijking mogelijk maken. Als alternatief wordt wel voorgesteld om bedrijfsresultaten formulematig tussen groepsmaatschappijen te verdelen, bijvoorbeeld op basis van omzet, vermogen, activa of werknemersaantallen. Dergelijke meer harde regels zouden minder ruimte bieden voor arbitrage. Een dergelijk stelsel zal echter alleen mogelijk zijn zonder een welvaartbeperkende hoeveelheid dubbele belastingheffing, wanneer het wereldwijd of regionaal op een consistente wijze wordt ingevoerd. Vanwege het tegengestelde belang tussen de verschillende grote economieën, is het echter onwaarschijnlijk dat over de parameters van het stelsel politieke overeenstemming kan worden bereikt. Dit accepterende is het beter om naar alternatieven te zoeken. Het versterken van procedures voor het verkrijgen van zekerheid vooraf of het verbeteren van regelingen voor onderling overleg tussen landen bij het oplossen van verrekenprijsc conflicten zijn daar voorbeelden van. De OESO heeft aan beide aandacht besteed als onderdeel van haar recente BEPS project. Helaas werden in de finale rapporten geen voorstellen gedaan, die er specifiek op waren gericht om de effectieve tijd van beide processen te verbeteren in situaties waarbij een CCA is betrokken. Dat is een gemiste kans, omdat dergelijke situaties tot specifieke problemen kunnen leiden, die moeilijk, zo niet onmogelijk op te lossen zijn onder de bestaande procedures. De voornaamste reden daarvoor is dat een CCA meestal multilateraal is, dat willen zeggen deelnemers uit meer dan twee landen heeft. Bij gevolg heeft een afspraak over verrekenprijzen met overheden alleen sluitende dekking, indien alle betrokken autoriteiten hierop aftekenen. Indien meer multilaterale afspraken zouden worden gemaakt, zou dat niet alleen dubbele belastingheffing vermijden maar ook de transparantie vergroten, een beter inzicht in verrekenprijzenproblematiek geven, schadelijke belastingconcurrentie tussen landen tegengaan en een eerlijkere verdeling van de belastinggrondslag bewerkstelligen. Om deze redenen zou de OESO het bereiken van multilaterale afspraken verder moeten bespoedigen, bijvoorbeeld door een standaard te ontwikkelen voor het verzoek dat belastingplichtigen zouden moeten indienen wanneer zij een CCA willen voorleggen en deze te publiceren als een bijlage bij Hoofdstuk 8 van de Verrekenprijzenrichtlijnen. In Paragraaf 10.2 is een aanzet voor een dergelijke standaard gegeven, door de minimale inhoud ervan verder uit te werken.

De effectiviteit van regelingen voor onderling overleg opgenomen in modelbelastingverdragen wordt beperkt door hun niet-bindende en niet-verplichtende karakter. Er lijkt echter wel een positieve trend te zijn om meer bindende en verplichtende regelingen overeen te komen, zoals bijvoorbeeld ook is afgesproken in een EU-context. Daarnaast zou het helpen om onenigheid over de uitkomst van CCA's op te lossen, wanneer artikel 25 in het OESO modelverdrag zou worden uitgebreid met een regeling voor situaties waarin een aanpassing van verrekenprijzen in meer dan twee landen nodig is om economische dubbele belastingheffing te voorkomen. In Paragraaf 10.3 is hier een voorstel voor opgenomen, dat voorziet in een multilaterale of simultane bilaterale procedure.

Overwegingen ter Afsluiting

CCA's werden geïntroduceerd in de Verenigde Staten als een praktisch instrument voor de juridische en fiscale structurering van interne ontwikkeling van immateriële activa door multinationale ondernemingen. Ze hadden tot doel verrekenprijzencomplexiteit te verminderen, maar zijn daar slechts deels succesvol in gebleken. Weliswaar maken ze het onder omstandigheden mogelijk een interne overdracht van immateriële activa uit de weg te gaan, maar tegelijkertijd leiden ze tot nieuwe waarderingsproblematiek wat betreft de verschillende bijdragen aan de CCA van de deelnemers. Bovendien worden CCA's in de praktijk vaak gebruikt in op belastingontwijking gerichte structuren. Dat laatste heeft de overeenkomsten tot het middelpunt van fiscaal debat gemaakt. Ik ben van mening dat bona fide CCA's een bestaansrecht hebben als een legitiem instrument voor de structurering van groepstransacties. In het bijzonder wanneer ze worden gebruikt in niet-artificiële juridische en economische structuren. Daarbij is echter nadrukkelijk geen plaats voor deelname door briefvenbusmaatschappijen uit belastingparadijzen aan een CCA. Verder zouden alle bijdragen onder de CCA zoveel mogelijk op marktprijs moeten worden gewaardeerd, zowel wanneer het om de waardering van vooraf bestaande immateriële activa gaat als wanneer het de waardering van onder de CCA verrichte ontwikkelingsactiviteiten betreft. De onder het BEPS project aangepaste Verrekenprijzenrichtlijnen van de OESO adresseren beide hiervoor vermelde punten. Als daarnaast CFC-regels worden aangepast, zodat laag belast excessief rendement op immateriële activa bij de moedermaatschappij in de heffing wordt betrokken, dan ontstaat een beeld van een regime dat ruimte laat voor legitiem gebruik van CCA's en tegelijkertijd oneigenlijke aanwending van deze overeenkomsten effectief tegengaat. Ik hoop dat mijn onderzoek op relevante deelgebieden een bijdrage kan leveren aan de verdere invulling van een dergelijk regime.

Curriculum Vitae

Dennis Nijssen holds a master degree in Tax Law obtained at Maastricht University in 2004. He has worked as a tax advisor at Loyens & Loeff and as an in-house tax lawyer for AkzoNobel. In 2010 Dennis completed an executive LLM in International and EU Tax Law at the International Tax Center in Leiden and in 2012 he started as an external PhD student at the Radboud University Nijmegen. Since 1 January 2018 he is the global head of tax for Nouryon. Dennis is married and a father of two daughters.

An Analysis of Cost Contribution Arrangements as a Legitimate Transfer Pricing Instrument and a Tax Avoidance Tool

Dennis Nijssen

Technological advancement and globalization have dramatically impacted the business models of multinational enterprises (“MNEs”). This has complicated the taxation of these enterprises significantly. It becomes especially complex, when companies belonging to the same multinational group collectively develop (intangible) business assets or centralize the performance of (supporting) group services. Which group companies should then bear the costs and which are entitled to the additional profits generated through these activities?

MNEs often structure their intragroup collaboration in legal agreements that foresee in a joint ownership of results and that allocate the costs in proportion to each participant’s anticipated benefits. These agreements are commonly referred to as cost contribution arrangements (“CCAs”) or cost sharing arrangements (“CSAs”). This study analyzes the most relevant rules and regulations governing their tax and transfer pricing treatment and sets out to determine how effective those rules are at facilitating legitimate CCAs while countering their use in tax avoidance structures.



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